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Taxation of Fractional Programs: Flying Over Uncharted Waters

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TAXATION OF FRACTIONAL PROGRAMS: “FLYING OVER UNCHARTED WATERS”

PHILIP E. CROWTHER*

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I. INTRODUCTION

THE FRACTIONAL programs were designed to allow the program aircraft to be operated under Part 91 of the Federal Aviation Regulations (the FARs). It was expected that the participant in the fractional program (the "interest owner") would be entitled to the same tax benefits as any other aircraft owner operating under Part 91. For example, it was expected that the use of the aircraft would not be subject to the federal transportation tax and that the interest owner would be entitled to claim a depreciation deduction for income tax purposes. However, because of their novelty, fractional programs have proven difficult to characterize for tax purposes.

In the early days of aviation, the tax characterization of aircraft transactions was often resolved by considering the tax treatment of other forms of transportation, such as ships. Unfortunately, while there are programs with some similarities, there does not appear to be anything that is equivalent to a fractional program. We are flying over uncharted waters.

A. GENERAL DESIGN OF THE PROGRAM

1. *The Basic Agreements*

There are four basic agreements that are signed by each interest owner:

1. An agreement with the selling company to purchase an undivided interest in a particular aircraft and to resell the aircraft back to the selling company for fair market value at the end of a specified term (the "purchase agreement").
2. An agreement with the other joint owners of the aircraft to participate in the fractional program. (the "joint ownership agreement").
3. An agreement with the other joint owners of the aircraft to participate in an interchange of aircraft with

the owners of other aircraft (the “interchange agreement”).

4. An agreement with the management company to maintain and schedule the aircraft, and to provide pilots to the interest owner when the interest owner is using a program aircraft (the “management agreement”).

In many cases, the selling company and the management company are the same legal entity. In other cases, they are related legal entities.

2. *General Principles*

a. Part 91 vs. Part 135

For Federal Aviation Administration (FAA) purposes, aircraft are generally classified into three categories: private aircraft, charter aircraft and airline aircraft. Private aircraft are typically operated under Part 91 of the Federal Aviation Regulations (the FARs), charter aircraft are typically operated under Part 135 and airline aircraft are typically operated under Part 121. Our primary concern is with the distinction between Part 91 and Part 135. An aircraft owner would generally prefer to operate under Part 91, since there are fewer requirements and limitations regarding the operation of the aircraft. However, a Part 91 operator also cannot transport others for compensation or hire.

b. Operational Control

With certain exceptions, in order to operate an aircraft under Part 91, the user must accept responsibility for “operational control” of the aircraft.¹ This means that the user exercises full control over and bears full responsibility for the airworthiness and operation of the aircraft.² This is more than a token responsibility. If there is an incident, the FAA and the civil courts can hold the user responsible for the consequences.³

¹ “Operational control,” as defined in 14 C.F.R. § 1.1 (2002), “with respect to a flight, means the exercise of authority over initiating, conducting or terminating a flight.”

² Regulation of Fractional Aircraft Ownership Programs and On-Demand Operations, 66 Fed. Reg. 37520-21 (July 18, 2001) (to be codified at 14 C.F.R. pts. 13, 61, 91, 119, 125, 135, and 142).

³ The FAA can hold the user liable for “careless and reckless” operation and for other specific violations, depending on the nature of the incident. FAA General Operating & Flight Rules, 14 C.F.R. § 91.13 (2002). The civil courts can hold the user liable for damages resulting from negligent maintenance and/or negligent operation of the aircraft, depending on the nature of the incident.

c. Joint Ownership Agreement

There are at least two kinds of joint ownership agreements. One is an agreement between the joint owners of an aircraft that specifies their rights and duties relative to the aircraft. Generally, in order to operate the aircraft under Part 91, each of the joint owners must retain “operational control” of the aircraft and obtain the pilots for their respective periods of use. Another kind of joint ownership agreement is described in 14 C.F.R. § 91.501 (FAR 91.501), which allows a jointly owned aircraft to be operated under Part 91 where one of the joint owners provides the pilots for the other joint owners.⁴

d. Dry Lease vs. Wet Lease

An aircraft can be acquired by purchase or lease. Where an aircraft is acquired by lease, the FAA consequences will vary depending on whether the lease is a “dry lease” or a “wet lease.” A “dry lease” is a lease of the aircraft without the flight crew, while a “wet lease” is a lease of the aircraft with a flight crew.⁵ Under a dry lease, the lessee will generally have operational control, with the result that the aircraft can be operated by the lessee under Part 91. Under a wet lease, the lessor will generally have operational control, with the result that the aircraft must be operated under Part 135, unless an exception applies.

Because of the possibility for confusion, the FARs require that, for leases of large civil aircraft, the lease agreement be in writing and contain a “truth in leasing” statement which clearly states whether the lessor or lessee has operational control of the aircraft.⁶

e. Interchange Agreements

There are many kinds of interchange agreements. One kind is an agreement between property owners to engage in a “dry lease interchange” of their property.⁷ Aircraft acquired pursu-

⁴ 14 C.F.R. § 91.501(b)(6), (c)(3) (2002).

⁵ See, e.g., Truth in Leasing, FAA Advisory Circular No. 91-37A (Jan. 16, 1978), at para. 5.

⁶ 14 C.F.R. § 91.23(a), (a)(2) (2002). A “large aircraft” is “an aircraft of more than 12,500 pounds, maximum certificated takeoff weight.” 14 C.F.R. § 1 (2002).

⁷ Such exchanges are common in the trucking industry, the railroad industry and the container industry. See, e.g., IRS Market Segment Specialization Program (MSSP) “Trucking Industry” (An interchange is defined in the Glossary as “[t]he transfer of equipment from one carrier to another.”). See also Tech. Adv. Mem. 82-41-010 and *William Weiss v. Comm’r*, T.C. Memo. 1987-505 (1987) (discussing

ant to such an interchange agreement could be operated under Part 91 as long as the user assumes responsibility for operational control of the aircraft. Another kind of interchange agreement is described in FAR 91.501 which allows aircraft operators to engage in a "wet lease interchange" of their aircraft on an hour for hour basis.⁸ In either case, compliance with the truth in leasing rules is required.⁹

f. Management Company

Many Part 91 owners and lessees hire a management company to manage their aircraft and to provide pilots. This is allowed under Part 91, as long as the owner or lessee retains operational control of the aircraft.

In many cases, a Part 91 operator will use a management company that is also a charter company so that they can dry lease the aircraft to the management company for use in their charter business. In such cases, the management company will also assume responsibility for scheduling the aircraft.

3. *Operation of the Program*

The characterization of fractional programs for FAA purposes has been the source of some confusion. Part of this confusion is created by the language of the fractional documents. The original fractional documents were submitted to and approved by various FAA regional offices. Once those documents had been approved, the fractional companies were understandably reluctant to change the documents, even after it became obvious that the documents might have been more artfully drafted.¹⁰

In practice, the interest owner does the following:

1. Acquires an undivided interest in a particular aircraft from the selling company.
2. Enters into a joint ownership agreement with the other joint owners of the aircraft.

the use of interchange agreements in the railroad industry) and *Norfolk Southern Corp. v. Comm'r*, 104 T.C. 417 (1995) (discussing the use of interchange agreements in the intermodal container industry).

⁸ 14 C.F.R. § 91.501(b)(6), (c)(2) (2002).

⁹ 14 C.F.R. § 91.23 (2002).

¹⁰ See discussion of the FAA history in Eileen M. Gleimer, *When Less Can Be More: Fractional Ownership of Aircraft - The Wings of the Future*, 64 J. AIR L. & COM. 979 (1999).

3. Agrees to engage in a dry lease exchange of their aircraft interest with other owners, which provides the interest owner with access to a whole aircraft for a certain number of hours.
4. Assumes responsibility for operational control of any aircraft used by the interest owner.
5. Hires the management company to provide maintenance on the aircraft owned by the interest owner, to provide pilot services on the aircraft used by the interest owner and to provide scheduling services for both.
6. Resells their aircraft interest to the selling company at the end of a specified term for fair market value.

These same elements are incorporated in the proposed FARs.¹¹

a. Joint Ownership Agreement

Because FAR 91.501 refers to a “joint ownership agreement” in which one joint owner provides the flight crew for other joint owners, some have been led to believe that a fractional “joint ownership agreement” contemplates the same thing. However, a fractional joint ownership agreement is merely an agreement between the joint owners of the aircraft and does not contemplate that any joint owner will provide the flight crew.¹²

¹¹ Proposed 14 C.F.R. § 91.1001(b)(1) provides that:

A fractional ownership program or program means any system of aircraft exchange involving two or more airworthy aircraft that consists of all of the following elements:

- (i) The provision for fractional ownership program management services by a single fractional ownership program manager on behalf of the fractional owners;
- (ii) One or more fractional owners per program aircraft, with at least one program aircraft having more than one owner;
- (iii) Possession of at least a minimum fractional ownership interest in one or more program aircraft by each fractional owner;
- (iv) A dry-lease aircraft exchange arrangement among all of the fractional owners; and
- (v) Multi-year program agreements covering the fractional ownership, fractional ownership program management services, and dry-lease aircraft exchange aspects of the program.

66 Fed. Reg. 37,520, 37,540-41 (July 18, 2001) (to be codified at 14 C.F.R. pts. 13, 61, 91, 119, 125, 135, and 142).

¹² Gleimer, *supra* note 10, at 1000-01.

b. Dry-Lease Exchange

The “dry-lease exchange” is the most unique aspect of the fractional programs. Many fractional documents indicate that the fractional program utilizes a “wet lease interchange” under FAR 91.501. However, in operation, this is not the case.¹³ Although the fractional programs do involve a lease of the aircraft interest from one interest owner to another, they do not involve a “wet lease” because the interest owner does not also provide the pilots.¹⁴ Furthermore, the fractional programs do not involve an hour for hour interchange.¹⁵ For these reasons, the arrangement is now referred to as a “dry lease exchange.”

c. Operational Control of Aircraft Used

In order to allow the aircraft to be operated under Part 91, the fractional documents have always provided that, where the fractional participant uses a program aircraft, the participant has “operational control” of that aircraft. The proposed FARs insure that the interest owner is fully aware of the consequences of having operational control, by requiring the interest owner to acknowledge that by accepting responsibility for operational control of the aircraft, the owner: (i) has responsibility for compliance with all Federal Aviation Regulations applicable to the flight; (ii) “may be exposed to enforcement actions for any non-compliance;” and (iii) “may be exposed to significant liability risk in the event of a flight-related occurrence that causes personal injury or property damage.”¹⁶

d. Management of Aircraft Owned and Used

The management company also serves a multiple purpose: to insure that the aircraft owned by the interest owner is properly maintained; to effectively insure that the aircraft leased from other aircraft owners is properly maintained and to provide pilots; and to schedule the use of the aircraft.

¹³ *Id.*

¹⁴ Proposed 14 C.F.R. § 91.1001(b)(2) defines a “dry-lease aircraft exchange” as “without crew.” 66 Fed. Reg. at 37,541 (July 18, 2001).

¹⁵ Most programs allow lower or higher value aircraft to be used and do not require an hour for hour exchange. For example, where a lower value aircraft is used, the participant is charged for less than an hour of use and where a higher value aircraft is used, the participant is charged for more than an hour of use.

¹⁶ 66 Fed. Reg. at 37,542 (July 18, 2001) (to be codified at 14 C.F.R. § 91.1013).

4. *Economic Analysis of the Program*

Assuming that fractional aircraft, can be operated under Part 91, the primary motivation for fractional programs is one of economics. To understand the economics of a fractional program, we will first consider the general economics of aircraft ownership, and then consider the incremental impact of using a management company, of using a joint ownership arrangement and of participating in a fractional program.

The costs of aircraft ownership are generally broken down into the following categories:

1. Capital costs - the costs of purchasing the aircraft, including interest costs, as well as the depreciation in value of the aircraft.
2. Direct operating costs - the direct costs of a flight, such as fuel, and landing and parking fees.¹⁷
3. Indirect operating costs - all the other costs of aircraft ownership, including insurance, hangar rental, salaries of flight crew and support staff, training costs, and aircraft maintenance costs.

Aircraft utilization is generally measured in hours. Because the capital costs and most of the indirect operating costs do not vary with usage, the average hourly cost of usage can be reduced by increasing usage. In rough numbers, a typical business aircraft is used for about 400 hours per year.¹⁸ Although there are cases where aircraft have been used for more than 800 hours per year, this generally requires a great deal of scheduling and maintenance expertise. One of the difficulties with increasing

¹⁷ 14 C.F.R. § 91.501(d) lists the following kinds of "direct operating costs:"

- (1) Fuel, oil, lubricants, and other additives.
- (2) Travel expenses of the crew, including food, lodging, and ground transportation.
- (3) Hangar and tie-down costs away from the aircraft's base of operation.
- (4) Insurance obtained for the specific flight.
- (5) Landing fees, airport taxes, and similar assessments.
- (6) Customs, foreign permit, and similar fees directly related to the flight.
- (7) In flight food and beverages.
- (8) Passenger ground transportation.
- (9) Flight planning and weather contract services.

¹⁸ AL CONKLIN & BILL DE DECKER, *AIRCRAFT ACQUISITION PLANNING* 140 (1998) ("The average annual utilization for operators who are members of the National Business Aviation Association (i.e. mostly corporate operators) is about 420 hours per year per aircraft for jets and turboprops.").

utilization is that the hours associated with repositioning the aircraft ("deadhead hours") will also increase at a greater rate.¹⁹ Eventually, a point is reached where the cost of the deadhead flights exceed the savings associated with greater utilization.

With regard to personnel, the aircraft owner can hire pilots and others with the expertise to insure that the aircraft is properly maintained and to schedule the use of the aircraft. Alternatively, the owner can hire a management company to do these same things. Where the management company is hired to insure that the aircraft is properly maintained, the owner will generally pay a monthly management fee to the company. Where the aircraft owner obtains the pilots from the management company, the owner will generally pay an hourly or monthly fee for the use of the pilots. The owner can allow the management company to use the aircraft for repositioning, maintenance and training flights and, if the aircraft is so used, the owner can reimburse the management company for the direct operating costs of those flights.

Where the owner does not need a "whole aircraft," the owner can join with others to jointly purchase an aircraft. This has the effect of reducing the capital costs for each participant. Each owner will pay the direct operating costs associated with its use of the aircraft and a proportionate share of the indirect operating costs. The joint owners can also hire a management company to manage the aircraft, to provide pilots and to schedule the use of the aircraft between the joint owners. From an economic standpoint, each joint owner should receive benefits that are proportional to the contribution made. This can prove challenging because some joint owners may end up using the aircraft more than others and because indirect operating costs may vary based on usage and other factors. The aircraft must be available to the users on a fair basis, which requires a mechanism to handle holiday usage and periods where the aircraft is parked away from the home base unused. A management company can sometimes help alleviate these problems by arranging for an exchange of aircraft between customers.

A fractional program provides joint owners with a formal mechanism for sharing their aircraft with other joint owners - the "dry lease exchange." A single management company is uti-

¹⁹ See, e.g., *id.* For example, in the case of an aircraft which is used for either 250, 500, 750 or 1,000 hours, the number of deadhead hours is, respectively, 0, 20, 60 and 120.

lized to manage the aircraft, to provide pilots and to schedule the use of the aircraft. Each owner pays an hourly charge associated with its use of the aircraft and a monthly management fee. The fractional program faces many of the same problems as joint ownership, since the program must insure that each interest owner receives benefits that are proportional to the contribution made. The availability issue is generally handled by guaranteeing that an aircraft will be available within a certain period.

From an economic standpoint, the primary advantage of a fractional program is that aircraft utilization can be increased significantly. Once a flight is completed, the aircraft does not have to be flown deadhead back to the home base. Instead, the aircraft is simply flown to where the next customer is located. Because of this, fractional companies are typically able to utilize an aircraft more efficiently, generally in excess of 1,000 hours per year. These increased efficiencies help offset the increased scheduling costs. The result is that the hourly cost of owning an operating a fractional aircraft lies somewhere between the hourly costs associated with owning a whole aircraft and the hourly costs of flying charter.

5. *Tax Analysis of the Program*

In general, the tax analysis of fractional programs will proceed in the same manner as the economic analysis- by considering first the existing tax rules relating to the ownership and use of an aircraft, to the use of a management company, to the use of a joint ownership arrangement and to the use of a "dry lease exchange." Next, we will consider how fractional programs are characterized or should be characterized for the purpose of each tax. Finally, we will consider the consequences of that characterization and any remaining issues.

II. FEDERAL TRANSPORTATION TAX

A. THE GENERAL RULES

1. *The Transportation Tax*

The current version of the federal transportation tax is part of the Internal Revenue Code of 1986, and is codified in 26 U.S.C. §§ 4261 *et seq.* (I.R.C. §§ 4261 *et seq.*).

a. A History of the Tax

The first federal transportation tax was enacted in 1917 to help finance the war effort and applied to the transportation of persons or property "by rail or water or by any form of mechanical motor power."²⁰ The tax was repealed in 1921.²¹ In 1941, with war again imminent, Congress enacted a tax on the transportation of persons.²² This was followed in 1942 by a tax on the transportation of property.²³ This tax applied to transportation "by rail, motor vehicle, water, or air" and was broad enough to apply to the transportation of people by bus and of property by household movers.²⁴ The tax on transportation of property was repealed in 1958, leaving only the tax on transportation of persons.²⁵ In 1962, the tax was further limited to apply only to transportation of persons by air.²⁶

b. The Airport and Airways Revenue Act of 1970

In 1970 both the transportation and fuel taxes were extensively revised as part of the Airport and Airway Revenue Act of 1970.²⁷ These changes were made to convert the tax into a "user fee" which would be used to fund development of the air transportation system.²⁸ The tax on air transportation of property was reenacted, and the exemptions for sales to federal, State and local governments were removed. A head tax on international travel was enacted to help compensate for the use of international travel facilities.²⁹

²⁰ Revenue Act of 1917, Pub. L. No. 65-50, 40 Stat. 300; Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057.

²¹ Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227. It does not appear that the tax was ever applied to air transportation.

²² Internal Revenue Code of 1939, 26 U.S.C. §§ 3469 *et seq.*, added by the Revenue Act of 1941, Pub. L. No. 77-250, 55 Stat. 687. In the Internal Revenue Code of 1954, these were reenacted and renumbered as 26 U.S.C. §§ 4261 *et seq.*

²³ Internal Revenue Code of 1939, §§ 3475 *et seq.*, added by the Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 957. In the Internal Revenue Code of 1954, these were reenacted and renumbered as 26 U.S.C. §§ 4271 *et seq.*

²⁴ Rev. Rul. 57-356, 1957-2 C.B. 758 (household goods).

²⁵ Tax Rate Extension Act of 1958, Pub. L. No. 85-475, 72 Stat. 259.

²⁶ Tax Rate Extension Act of 1962, Pub. L. No. 87-508, 76 Stat. 114.

²⁷ Airport and Airway Development and Revenue Acts of 1970, Pub. L. No. 91-258, 84 Stat. 219.

²⁸ According to the Senate Report: "[T]he taxes on the transportation of persons and property by air are now generally viewed as user charges properly applicable in the case of all users." S. REP. NO. 91-706, at 396 (1970), *reprinted in* 1970-1 C.B. 386, 396.

²⁹ I.R.C. § 4261(c) (West 1994).

The transportation tax was to work in tandem with the fuel tax. A flight was subject to either the transportation tax or the fuel tax, but not both.³⁰ The revenues collected from both taxes were to be deposited into the Airport and Airways Trust Fund.

c. Current Law

The transportation tax was further complicated in 1997 with the addition of the domestic segment fee.³¹ Currently, the transportation of persons by air is subject to the following taxes:

1. The 7.5% tax on the amount paid for taxable transportation (the "percentage tax").³²
2. A \$3 tax on the amount paid for each domestic segment (the "domestic segment tax").³³
3. A \$13.20 per person head tax on the amount paid for taxable transportation that begins or ends in the United States (the "head tax").³⁴

There are certain exemptions. The transportation tax does not apply to flights in an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less, except when the aircraft is operated on an "established line."³⁵ The transportation tax also does not apply where one member of an affiliated group provides transportation to another member of the group.³⁶

d. "Possession, Command and Control"

In order to determine whether the use of an aircraft should be considered a taxable transportation service, the IRS relies on the "possession, command and control" test, which appears to have been borrowed from maritime law.³⁷ This test was first articulated in the context of a lease, where the IRS stated that:

³⁰ See, e.g., Rev. Rul. 72-156, 1972-1 C.B. 331 ("[T]he objective of the Act is to have one set of taxes (either the transportation taxes or the fuel taxes) and not two sets apply to any one use of an aircraft.").

³¹ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 929.

³² I.R.C. § 4261(a) (West 2002).

³³ I.R.C. § 4261(b)(1) (West 2002). This will be adjusted for inflation.

³⁴ I.R.C. § 4261(c) (West 2002). The head tax was originally \$12, but has been increased for inflation.

³⁵ I.R.C. § 4281 (West 2002).

³⁶ I.R.C. § 4282(a) (West 2002).

³⁷ See, e.g., *Leary v. United States*, 81 U. S. 607, 610 (1871) (referring to "command and possession, and control"). See also Rev. Rul. 74-170, 1974-1 C.B. 175 (distinguishing between a "bareboat" charter where "the charterer is in complete possession, control, and command of the vessel" and a time charter or voyage charter, where the ship owner retains these elements).

Where the owner of a vehicle . . . leases it to others for the transportation of persons but retains possession, command, and control of the vehicle, he is furnishing a taxable transportation service However, where the owner of the vehicle transfers the complete possession, command, and control of his vehicle to a lessee, either by a charter-party or by actual practice, the owner is not engaging in a taxable transportation service but is merely leasing his vehicle.³⁸

Under this test, where a lessor provides both the aircraft and the flight crew, the transportation tax will generally apply since the lessor will generally be viewed as having "possession, command and control" of the aircraft.³⁹ However, where the lessor provides only the aircraft, the transportation tax will generally not apply.⁴⁰ In later rulings, the IRS adopted the FAA terminology, holding that a "wet lease" (aircraft and flight crew) is taxable transportation, while a "dry lease" (aircraft only) is a nontaxable rental.⁴¹ In recent rulings, the IRS has also referred to the FAA concept of "operational control" for determining who has "possession, command and control" of the aircraft.⁴²

e. Commercial vs. Noncommercial Transportation

For tax purposes, a distinction is made between commercial and noncommercial transportation. Although the term "commercial" does not appear in the transportation tax law, the term "noncommercial" appears in the fuel tax law.⁴³ The term "noncommercial transportation" is defined in the fuel tax law as "any use of an aircraft, other than use in a business of transporting persons or property for compensation or hire by air."⁴⁴ Because the transportation tax and the fuel tax were designed to work in tandem, the resulting generalization is that the transportation tax applies to commercial transportation while the fuel tax applies to noncommercial transportation.⁴⁵

³⁸ Rev. Rul. 60-311, 1960-2 C.B. 341, 342.

³⁹ See, e.g., Rev. Rul. 60-311, 1960-2 C.B. 341.

⁴⁰ See, e.g., Rev. Rul. 72-394, 1972-2 C.B. 576.

⁴¹ See, e.g., Rev. Rul. 68-256, 1968-1 C.B. 489; Rev. Rul. 72-617, 1972-2 C.B. 580 (taxable wet lease); Tech. Adv. Mem. 81-31-051 (May 8, 1981) (nontaxable dry lease); Priv. Ltr. Rul. 88-26-057 (April 5, 1988) (taxable wet lease).

⁴² Tech. Adv. Mem. 93-47-007 (Aug. 12, 1993) and 94-04-007 (Oct. 20, 1993).

⁴³ I.R.C. § 4041(c)(2) (West 2002).

⁴⁴ *Id.*

⁴⁵ See, e.g., S. REP. NO. 91-706 (1970), *reprinted in* 1970-1 C.B. 386, 397:

[i]t is necessary to determine on a flight-by-flight basis whether the aircraft is being used in a business of transporting persons or prop-

The tax definition of “noncommercial transportation” is fairly consistent with the FAA definition of “commercial operator.”⁴⁶ Nevertheless, the IRS has ruled that a person’s status as a commercial operator for FAA purposes is not determinative for tax purposes.⁴⁷ Instead, the IRS has consistently used the “possession, command and control” test to distinguish between commercial and noncommercial transportation.

f. Amount Paid

The transportation tax is imposed on the “amount paid” for the taxable transportation.⁴⁸ The amount paid does not include payments for non-transportation items.⁴⁹ The amount paid is not adjusted to reflect the fair market value of the transportation, even if the amount paid for the transportation is less than the fair market value of that transportation.⁵⁰ For example, where employees are entitled to free flights or to reduced-cost flights, the IRS has ruled that the tax is based on the amount actually paid by the employees.⁵¹

In some situations, the IRS has ruled that the amount paid includes not only the cash paid to the person providing the transportation, but the amounts paid to others. For example, in Rev. Rul. 60-311, the IRS held that “where a company receiving transportation service supplies the carrier with items which represent necessary elements of transportation (such as gas, oil, lubricants, equipment, or insurance), such items are considered

erty for compensation or hire. . . . [I]f the aircraft is being used in such a business (an example of which would include a passenger or freight air charter flight), the taxes imposed by section 4261 and 4271 would be applicable and there would be no fuel tax imposed by section 4041(c).

⁴⁶ 14 C.F.R. § 1.1 (2002) provides that, “‘Commercial operator’ means a person who, for compensation or hire, engages in the carriage by aircraft in air commerce of persons or property, other than as an air carrier or foreign air carrier or under the authority of Part 375 of this title.”

⁴⁷ Rev. Rul. 78-75, 1978-1 C.B. 340.

⁴⁸ I.R.C. § 4261(a) (West 2002) (percentage tax); I.R.C. § 4261(b)(1) (West 2002) (segment tax); I.R.C. § 4261(c)(1) (West 2002) (foreign head tax). In Rev. Rul. 72-245, 1972-1 C.B. 347, the IRS ruled that as long as there is any “amount paid” for transportation, the entire foreign head tax can be collected. Presumably, the same rule would apply to imposition of the segment tax.

⁴⁹ See Treas. Reg. § 49.4261-8 (as amended in 1962); Rev. Rul. 57-545, 1957-2 C.B. 749; Priv. Ltr. Rul. 86-36-043 (June 6, 1986); Priv. Ltr. Rul. 87-21-053 (Feb. 19, 1987).

⁵⁰ Rev. Rul. 72-245, 1972-1 C.B. 347; Rev. Rul. 70-381, 1970-2 C.B. 270; Rev. Rul. 60-152, 1960-1 C.B. 547.

⁵¹ Rev. Rul. 72-245, 1972-1 C.B. 347.

to be payments for transportation.”⁵² In other situations, the IRS has ruled that the amount paid also includes the value of the use of the aircraft.⁵³ For example, in Rev. Rul. 74-123, the IRS ruled that where a transportation company provided taxable transportation services using both their own aircraft and customer-owned aircraft, the “amount paid” included the value of the use of the customer aircraft.⁵⁴ In Tech. Adv. Mem. 86-09-009, the IRS ruled that employees should be taxed on the value of aircraft used for personal transportation, even where no amount was paid by the employee.⁵⁵ This ruling was quickly revoked and replaced with Tech. Adv. Mem. 86-51-005, which reaffirmed that no taxable amount had been paid.⁵⁶ To date, no court has ruled on whether taxes can be imposed on payments to third parties or on the value of the use of an aircraft.

2. *Taxation of Use of Own Aircraft*

As a general rule, the owner of an aircraft will not be taxed on his own use of that aircraft, even where the owner hires a management company to maintain the aircraft and provide the pilots. Nevertheless, in a few cases, the IRS has held that the transportation tax applied because the owner relinquished possession, command and control of the aircraft.

a. Rev. Rul. 58-215

In Rev. Rul. 58-215, the IRS ruled that an aircraft owner (“the corporation”) was not receiving transportation services from a management company (“airline company”).⁵⁷ This ruling predates the adoption of the “possession, command and control” test. The owner purchased the aircraft from the management company and entered into an agreement that appointed the management company “to service, maintain, overhaul and operate the aircraft.”⁵⁸ As part of this agreement, the management company provided the flight crew (a pilot and co-pilot), subject to the approval of the owner. The flight crew was under the

⁵² Rev. Rul. 60-311, 1960-2 C.B. 341, 342.

⁵³ See, e.g., Rev. Rul. 74-123, 1974-1 C.B. 318 (value of use of own aircraft).

⁵⁴ *Id.*

⁵⁵ Tech. Adv. Mem. 86-09-009 (Nov. 21, 1985).

⁵⁶ Tech. Adv. Mem. 86-51-005 (Sept. 10, 1986).

⁵⁷ Rev. Rul. 58-215, 1958-1 C.B. 439.

⁵⁸ *Id.* at 439.

“exclusive control” of the owner, subject to the discretion of the flight crew “as to safety of operation.”⁵⁹

The owner reimbursed the management company for the costs of maintaining and overhauling the aircraft and paid the management company a fixed amount to cover the salaries of the flight crew. With respect to each flight, the owner paid the management company a specified amount per hour to cover the direct costs of operation, including “gasoline, oil, and hydraulic fluid.”⁶⁰ The owner reimbursed the management company for landing fees.

The owner purchased liability insurance on the aircraft listing the management company as an additional named insured. The management company indemnified the owner for any loss or damages arising out of the hangaring, maintaining, servicing, and overhauling of the aircraft. The management company also maintained workmen’s compensation and employees’ liability insurance on all its employees participating in, or in any way connected with, the operation of the aircraft.

Although not discussed in the ruling, the owner presumably paid the management company a fee for managing the aircraft and providing other services, such as weather reporting services.

Based on the facts presented, the IRS concluded that the management company was not providing transportation services to the owner:

It is held that, since the corporation [1] owns the aircraft, [2] has exclusive control over the aircraft’s personnel, [3] pays the operating expenses of the aircraft, and [4] maintains liability and risk insurance and [5] the airline operates the aircraft as an agent for the corporation, the airline company is not, with respect to this service, furnishing a transportation service for hire.⁶¹

b. Rev. Rul. 74-123

In Rev. Rul. 74-123, the IRS held that the owner of an aircraft had relinquished possession, command and control of the aircraft.⁶² This ruling is often cited as a case where the IRS concluded that an aircraft management company was engaged in providing taxable transportation services.⁶³ However, the state-

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* at 440 (numbers in brackets added).

⁶² Rev. Rul. 74-123, 1974-1 C.B. 318.

⁶³ See, e.g., Tech. Adv. Mem. 94-04-007 (Oct. 20, 1993).

ment of facts indicates that the aviation company was not hired to provide management services, but was hired to provide domestic air transportation services. The ruling states that, under the contract, the company "provides domestic air transportation for agency personnel on official business" and that the company "is obligated to operate the aircraft on scheduled flights between definite points in the United States as provided in the contract."⁶⁴ The unusual aspect of the arrangement is that the company used both its own aircraft and aircraft owned by the federal agency to provide this service.

Otherwise, the arrangement was identical to any other charter arrangement. The company was responsible for maintaining, repairing, insuring and storing the aircraft. The company paid all of the indirect and direct operating expenses, "except that the agency furnishes at no cost to the company such spare parts and built-up engines as may be required for such aircraft."⁶⁵ The company hired the flight crew and other necessary personnel, all of whom were under the company's "exclusive control, management and supervision."⁶⁶ The agency paid the company for the services at a specified rate that varied according to ownership and type of aircraft used and the number of crew members required.

Under this set of facts, there was no doubt that the aviation company was providing a transportation service to the government agency. Transportation tax applied to amounts paid by the government agency for the use of aircraft owned by the company. The question was whether the tax also applied where the transportation was provided in aircraft owned by the government agency. The IRS concluded that the tax should apply regardless of whose aircraft were used:

The transportation service provided by the company when it operates Government-owned planes is essentially the same service provided by the company when it uses its own aircraft. Under the circumstances of the case, the mere fact that the company uses Government-owned aircraft rather than its own in carrying out the contract is not sufficient to change the nature of the service as "taxable transportation," for purposes of the tax imposed by section 4261 of the Code.⁶⁷

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

In computing the amount subject to tax, the IRS also concluded that the same tax basis should be used:

In computing the transportation tax due on the part of the service that involves use of Government-owned aircraft, the "amounts paid" for the service include not only the amount of money actually paid, but also the value of any contribution made by the agency toward providing the service; for example, the value of the use of Government-owned aircraft, insurance expense, etc. *See* Rev. Rul. 60-311, 1960-2 C.B. 341. However, in lieu of computing the tax on the foregoing basis, the Internal Revenue Service will accept a tax computed on the amount the company would charge the agency for the particular service if a comparable company-owned rather than Government-owned aircraft were used.⁶⁸

As can be seen, Rev. Rul. 74-123 does not stand for the proposition that a management company can be engaged in providing transportation services and that, in such a case, the owner should be taxed on the value of the use of his own aircraft. Instead, the ruling stands for the proposition that where a company is hired to provide air transportation services, the tax consequences will not vary simply because the company is using aircraft provided by the customer.

c. Tech. Adv. Mem. 93-43-002

In Tech. Adv. Mem. 93-43-002, the IRS extended the principles of Rev. Rul. 58-215 to cover an arrangement involving an aircraft management company that was also a charter company.⁶⁹ In this case, the aircraft owner ("B") entered into an arrangement with a charter company ("A") providing that the charter company would operate and maintain the aircraft ("X aircraft") under its Air Taxi Certificate. The charter company provided pilots and fuel, except that the owner would pay all costs attributable to operating the aircraft for its use, including "the salaries and standby charges for the pilots and all expenses for fuel, insurance and overnight fees." The owner had the right to replace any of the pilots and "to direct such pilots as to when and where to fly subject to safety considerations."⁷⁰ The charter company also provided insurance on the aircraft under which the owner was the designated payee on all hull loss settle-

⁶⁸ *Id.*

⁶⁹ Tech. Adv. Mem. 93-43-002 (June 30, 1993).

⁷⁰ *Id.*

ment payments for the aircraft. The charter company had the option to use the aircraft for charter to unrelated third parties, as long as the charters did not infringe on the owner's right to use the aircraft.

The IRS held simply that the arrangement was similar to that in Rev. Rul. 58-215 and that the owner, like the owner in Rev. Rul. 58-215, retained "possession, command and control" of the aircraft. Consequently, the transportation tax did not apply to owner flights for which amounts were paid to the charter company.

d. Tech. Adv. Mem. 93-47-007

In Tech. Adv. Mem. 93-47-007, the IRS considered an arrangement involving a federal agency, similar to that described in Rev. Rul. 74-123.⁷¹ However, in this case, the IRS concluded that the owner had retained "possession, command and control" of the aircraft.

Under the contract with the federal agency ("*FA*"), the management company ("Corporation X") was required "to manage, operate, and maintain government-furnished aircraft and government-owned air facilities in transporting personnel and cargo of *FA* to and from locations specified by *FA* in the contract and other locations which *FA* may from time to time specify."⁷² The management company did not provide any of the aircraft used.

Although the pilots and support personnel were employed by the management company, the federal agency retained "substantial control" over the personnel. For example, key personnel were designated by name in the contract and the federal agency "set forth in the contract detailed specifications as to job qualifications and classifications, wage scales and benefits, labor standards, and security clearances for such personnel and the other employees." In addition, the federal agency established "the flight destinations, schedules and routes" and often, "for security and safety reasons," required the management company to use specified aircraft.

The management company was compensated for these services on an annual fixed-fee plus allowable costs basis. The management company had no risk of loss with respect to

⁷¹ Tech. Adv. Mem. 93-47-007 (Aug. 12, 1993).

⁷² *Id.*

government property, except for willful misconduct or lack of good faith.

The IRS held that the critical issue was whether the management company was an agent of the federal agency or, as the contract stated, an "independent contractor." The IRS concluded that:

Although *X* is referred to in the contract as an independent contractor, the totality of the contract provisions, particularly those whereby *FA* pays the operational expenses, retains and *exercises substantial operational control*, and assumes the risk of loss, indicate that *X* is acting as an agent of *FA*. The contract is in the nature of a management contract under which *X* acts as an agent in operating and maintaining *FA*'s aircraft with *FA*, the owner of the aircraft, being the principal who has possession, command and control of the aircraft.⁷³

The major differences between this arrangement and that described in Rev. Rul. 74-123 appear to be that, in this case: (1) the agreement did not specifically require the management company to provide transportation services; (2) the management company did not own any of the aircraft; and (3) the federal agency appeared to play a more active role in the selection of the pilots, the aircraft and the routes of flight.

3. *Taxation of Joint Ownership Agreement*

The IRS rulings relating to joint ownership agreements indicate that the presence of such an agreement will not cause the transportation tax to apply, even where the pilots are employed by only one of the joint owners.

In Priv. Ltr. Rul. 80-52-040 (and companion rulings), the IRS considered a joint ownership arrangement where an aircraft owner ("*M*") sold undivided interests in two aircraft to corporations in which it owned an interest ("*N, O, P, Q, R, S, T, and U*").⁷⁴ Following this sale, the aircraft was to be registered in the names of each of the co-tenants (*M* through *U*). Each of the co-tenants would pay a pro-rata share of the indirect and capital costs, including "hangar rental, property taxes, insurance, debt service, maintenance and depreciation."⁷⁵ The co-tenants would pay the direct operating costs, such as "fuel expenses, landing fees, hangar rental when the aircraft are hangared away

⁷³ *Id.*

⁷⁴ Priv. Ltr. Rul. 80-52-040 (Sept. 30, 1980).

⁷⁵ *Id.*

from their home hangar, and pilot expenses" attributable to their use of the aircraft.⁷⁶ The flight crew would continue to be employed by M who would enter into agreements to furnish flight crew to each of the other co-tenants. However, any co-tenant could terminate this agreement and engage its own pilots to operate the aircraft: Pilots furnished to any co-tenant would "be under that co-tenant's exclusive control, subject to the discretion of pilots as to safety."⁷⁷ The co-tenants using M's pilots would pay M a pro-rata share of the pilot salaries for each month, based on their proportionate use of the pilots.

The IRS concluded that this arrangement was similar to the aircraft management approved in Rev. Rul. 58-215. Regarding the aircraft, the IRS noted that, "As owners of an undivided interest in the aircraft, the co-tenants have equal rights to the possession and use of the aircraft. The co-tenants will not rent or lease the aircraft from the others; rather they will merely use their own aircraft."⁷⁸

Regarding the pilots, the IRS noted that, "As in Rev. Rul. 58-215, M and its proposed co-tenants will fully control the aircraft's pilots, subject to the pilot's discretion as to safety of the aircraft. The co-tenants will be free at any time to discharge a pilot furnished by M and engage a pilot of their choosing."⁷⁹

Accordingly, the IRS concluded that the transportation tax did not apply to amount paid by the co-tenants. The IRS reached the same conclusion in a later ruling involving two aircraft and three co-owners.⁸⁰

4. *Taxation of Dry Lease Exchange*

The use of a "dry lease exchange" should not cause the transportation tax to apply. The IRS has ruled on a number of occasions that the "wet lease" interchange of an aircraft is a transportation service.⁸¹ Similarly, the IRS has ruled that the transportation tax applies where the owner of an aircraft exchanges a "dry-lease" of his aircraft for a "wet lease" of the same

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ Priv. Ltr. Rul. 81-48-029 (Sept. 1, 1981). See also Priv. Ltr. Ruls. 81-48-030 (Sept. 1, 1981) and 81-48-032 (Sept. 1, 1981).

⁸¹ Tech. Adv. Mem. 95-02-004 (Sept. 6, 1994), supplementing Tech. Adv. Mem. 94-41-005 (June 27, 1994); Priv. Ltr. Rul. 93-16-035 (Apr. 23, 1993); Priv. Ltr. Rul. 90-22-011 (June 1, 1990); Tech. Adv. Mem. 78-22-026 (Mar. 6, 1978).

aircraft.⁸² In these cases, the IRS has held that the transaction is similar to a barter exchange and that the amount subject to tax should include the value of the use of the aircraft and crew.⁸³

However, where a “dry lease” is involved, the IRS has ruled that the transportation tax does not apply.⁸⁴

a. Priv. Ltr. Rul. 6905161860A

In Priv. Ltr. Rul. 6905161860A, the IRS approved an arrangement where a management company would occasionally transport a customer in another customer’s aircraft.⁸⁵ Under the management contract, the company agreed to operate the customer’s aircraft, to maintain and service the aircraft, to provide the flight crew, to provide property and liability insurance, a hangar and to arrange for dispatch and weather service. Each customer had “exclusive control over the time and place of each flight subject only to discretionary control by [the management company] and the pilot on safety matters.”⁸⁶ From time to time a customer would use an aircraft owned by another aircraft. This would happen when the customer “has an immediate need for a plane but does not have one of its own available.”⁸⁷ According to the ruling, “This exchange of planes is on an informal basis, but requires the consent of the customer whose plane is available.”⁸⁸ The customer using the aircraft would pay all of the actual operating costs, but nothing was paid for the use of the plane.

No question was raised regarding the customer’s use of its own aircraft since it was believed that the arrangement “is similar to that described in Revenue Ruling 58-215.”⁸⁹ Instead, the question was whether transportation tax applied where the customer used another customer’s plane. The IRS concluded that,

⁸² Tech. Adv. Mem. 78-30-003 (Mar. 21, 1978).

⁸³ See, e.g., Tech. Adv. Mem. 95-02-004 (Sept. 6, 1994) (“The arrangement between the taxpayer and the other corporation is essentially a barter exchange. In this connection, amounts paid include not only cash, but also payments in kind”). See also Tech. Adv. Mem. 94-14-005 (Jan. 14, 1994) (A barter agreement to exchange products or services (e.g., legal or accounting services) for air transportation is subject to transportation tax when the transportation is received).

⁸⁴ See, e.g., Rev. Rul. 68-256, 1968-1 C.B. 489; Tech. Adv. Mem. 81-31-051 (May 8, 1981).

⁸⁵ Priv. Ltr. Rul. 6905161860A (May 16, 1969).

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

"Pursuant to the provisions of section 4261 of the Code, and consistent with Revenue Ruling 58-215, we have concluded that, under the circumstances stated, you are not, with respect to either of the set of circumstances described, furnishing a transportation service for hire."⁹⁰

B. CHARACTERIZATION OF FRACTIONAL PROGRAMS

1. *The Fractional Company Rulings*

a. Tech. Adv. Mem. 93-14-002 and 94-04-006

In Tech. Adv. Mem. 93-14-002, the IRS reviewed one of the fractional programs (presumably the Executive Jet Aviation program) and concluded that the fractional owners had relinquished "possession, command and control" of the program aircraft to the management company ("the taxpayer").⁹¹

The IRS began by characterizing the taxpayer as a management company and "an air charter service," presumably a reference to the "core fleet."⁹² The IRS then discussed the basics of the fractional program, noting that the management company was responsible for managing and maintaining the aircraft and for providing the flight crew.

The IRS considered both Rev. Rul. 58-215 and Rev. Rul. 74-123 and recognized that, in both cases, the owner retained title to his own aircraft. Instead, as in Tech. Adv. Mem. 93-47-007, the IRS viewed the distinction as one of "agency," noting that "the airline company in Rev. Rul. 58-215 was acting as the aircraft owner's agent in the operation of the aircraft" while "in Rev. Rul. 74-123, the aviation company was acting as a principal in providing air transportation to the federal agency."

In Rev. Rul. 58-215, "the owner had exclusive control of the pilots, maintained insurance, and paid the operating expenses of the aircraft." In Rev. Rul. 74-123, "The aviation company provided the aircraft crew and support personnel and was responsible under the contract for operations, maintenance, and insurance expenses. The provision of the air transportation service to the federal agency when agency-owned aircraft were used

⁹⁰ *Id.*

⁹¹ Tech. Adv. Mem. 93-14-002 (Dec. 22, 1992).

⁹² Later in the ruling, the IRS noted that, "If there are no aircraft available pursuant to the interchange agreement, under the management agreement, the taxpayer provides, without compensation other than that provided for by the management agreement, an aircraft from its charter fleet." *Id.*

was essentially the same as when aviation company-owned aircraft were used.”⁹³

The IRS then concluded that, “In viewing the totality of the circumstances, including the agreements and the respective responsibilities of the parties, although the owners are the title holders to the aircraft, they have relinquished possession, command, and control, of their respective aircraft to the taxpayer who provides air transportation.”⁹⁴

The IRS gave several reasons:

The owners are obligated upon the purchase of an interest in an aircraft to sign agreements that effectively allow the taxpayer to treat the A program aircraft as part of its charter fleet. The taxpayer supplies and has command over the pilots and, even though the owners may designate which pilots they prefer, the taxpayer has ultimate control over assignment of crews. The taxpayer is responsible for operations, maintenance, and insurance expenses, and, depending on the nonavailability of the aircraft, provides transportation to an owner in any aircraft in the A program or within the taxpayer’s charter operation - thus in many instances transporting an owner in an aircraft in which it does not even have an ownership interest. Under the owners agreement, an owner generally cannot utilize an A program aircraft to transport passengers or cargo for compensation or hire. Therefore, the taxpayer is providing taxable air transportation of persons under section 4261(a) of the Code.⁹⁵

Having held that the situation was more like that in Rev. Rul. 74-123, the IRS also concluded that, “Additionally, as provided in Rev. Rul. 74-123, in computing the transportation tax, the ‘amount paid’ to the taxpayer includes not only the money actually paid by the owners, but also the value of the use of the aircraft provided by the owner.”⁹⁶

In Tech. Adv. Mem. 94-04-006, the IRS reaffirmed their position and denied the taxpayer request that Tech. Adv. Mem. 93-14-002 should be applied prospectively, disagreeing with taxpayer’s argument that they had reasonably relied on Rev. Rul. 58-215.⁹⁷

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ Tech. Adv. Mem. 94-04-006 (Oct. 12, 1993).

b. Tech. Adv. Mem. 94-04-007

Although Tech. Adv. Mem. 94-04-007 does not involve a fractional program, this ruling was issued at the same time as the second fractional company ruling. In this ruling the IRS concluded, apparently for the first time, that an aircraft owner had effectively relinquished possession, command and control of its aircraft to a management company ("the taxpayer").⁹⁸ However, there are significant differences between this ruling and other management company rulings.

The management company agreed to maintain the aircraft and to arrange for pilots and other ancillary personnel. The owners agreed to maintain insurance with respect to the aircraft. In addition, the management company had "the 'exclusive right to rent, charter, and schedule the aircraft' and 'full operational control over the aircraft.'" The owner of the aircraft was entitled to use its aircraft, "provided, however, that the aircraft has not been scheduled for hire by the taxpayer."⁹⁹ Owners Y and Z paid a per hour flight charge when they used their own aircraft.

Under these circumstances, the IRS concluded that the owners had relinquished "possession, command, and control" to the management company. Although the contracts provided that the taxpayer was an agent of the owner, the owners had given the taxpayer "not only all rights to charter the aircraft but also full *operational control* over the aircraft whether the air transportation is provided via charter to a third party or to an owner."¹⁰⁰ An owner was entitled to be transported in its own aircraft, "but only if the aircraft has not been scheduled for hire by the taxpayer."¹⁰¹ Despite their ownership of the aircraft, the IRS felt that "those owners have yielded possession, command, and control of the respective aircraft by virtue of their relinquishing virtually all decision making with regard to the operation and maintenance of the aircraft, whether under charter or in regard to the providing of air transportation to the owner."¹⁰²

A key factor in this ruling appears to be that, in contrast with Tech. Adv. Mem. 93-43-002, the owner had relinquished the right to use its own aircraft to the management company and that the owner had relinquished "operational control" of the air-

⁹⁸ Tech. Adv. Mem. 94-04-007 (Oct. 20, 1993).

⁹⁹ *Id.* (emphasis added).

¹⁰⁰ *Id.* (emphasis added).

¹⁰¹ *Id.*

¹⁰² *Id.*

craft to the management company. Taken together with Tech. Adv. Mem. 93-47-007, this ruling seemed to indicate that the IRS had finally come to recognize that “operational control” was a critical factor to be considered in determining whether possession, command and control had been relinquished. However, the fractional company rulings indicate otherwise.

2. *Executive Jet Aviation*

Following these rulings, Executive Jet Aviation (“EJA”) decided to take the matter to court. In accordance with the procedures applicable to excise tax claims, EJA filed a claim for refund of taxes paid on behalf of a particular customer, Texaco Air Services, Inc. (“Texaco Air”). In *Executive Jet Aviation, Inc. v. United States*, an unpublished opinion, the Court of Claims denied EJA’s claim for refund, holding that the transportation tax applied because EJA was engaged in the transportation business.¹⁰³ This decision was appealed.

In *Executive Jet Aviation, Inc. v. United States*, the Court of Appeals affirmed the decision of the Court of Claims and held that EJA was engaged in transportation business, and was not an aircraft management company.¹⁰⁴

The court began by considering EJA’s argument that the transportation tax did not apply because EJA did not have an interest in the aircraft, either as an owner or a lessor:

EJA argues that, in order for Texaco Air’s flights to have been subject to the § 4261 transportation tax, EJA had to provide the means for conveyance - either N111QS or another interchange aircraft. . . .

. . . . It contends that, on each of the flights at issue, Texaco Air was either the owner of the aircraft on which it flew or the lessee of the aircraft from the aircraft’s owners through the interchange agreement. Under these circumstances, EJA asserts, its only role with respect to each of the flights was that of an aircraft manager.¹⁰⁵

The court held that this interpretation was not supported by the language of the statute. To the contrary, the court held that, “The critical statutory provision is I.R.C. § 4041(c). Through it, commercial aviation, which is subject to the § 4261

¹⁰³ *Executive Jet Aviation, Inc. v. United States*, No. 95-7T (Fed. Cl. Mar. 29, 1996).

¹⁰⁴ *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463 (Fed. Cir. 1997).

¹⁰⁵ *Id.* at 1467-68.

transportation tax, is defined as 'any use of an aircraft . . . in a business of transporting persons or property for compensation or hire by air.'"¹⁰⁶

Since the statute required only that EJA "use" the aircraft, the court held that, "We reject EJA's argument that it was necessary for it to provide aircraft to Texaco Air by being an owner or lessor in order for Texaco Air's flights under the NetJets program to be subject to the transportation tax."¹⁰⁷

Instead, the court moved on to the second part of the test:

What we must determine then is whether, based upon the correct reading of the statute, the Texaco Air flights that are at issue involved "use of an aircraft . . . in a business of transporting persons or property for compensation or hire by air" 26 U.S.C. § 4041(c). *The central question is whether EJA was in the "business of transporting persons or property for hire by air,"* for it is undisputed that neither Texaco nor any of the other participants in the NetJets program were in such a business. In our view, as far as the NetJets program was concerned, EJA was in the "business of transporting persons or property for hire by air." Consequently, the transportation tax was properly imposed.¹⁰⁸

In determining whether EJA was a transportation company, the court acknowledged EJA's argument that they were merely a management company:

As noted, EJA argues that its role with respect to each of the flights was simply that of an aircraft manager for those who owned or leased interests in aircraft. We disagree. The NetJets program, which was administered and run by EJA, served parties like Texaco Air *who were interested in acquiring flight time, not an ownership or a leasehold interest in a corporate aircraft.* One could become a NetJets participant by acquiring only a one-eighth interest in an aircraft, and while in the interchange program, a participant might never actually fly aboard the aircraft in which it had purchased an interest. At the same time, at its own expense, EJA was required to inspect, service, repair, overhaul, and test the aircraft in order to maintain its FAA certification. EJA further agreed to pay for fuel and to pay the salary and the travel and lodging expenses of the crew. It also agreed to pay hangar and tie-down costs, landing fees, and in-flight food and beverage expenses. Finally, EJA agreed to obtain, at its own expense, all-risk aircraft hull insurance and liability insurance.¹⁰⁹

¹⁰⁶ *Id.* at 1468 (emphasis added).

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* 1468-1469 (emphasis added).

¹⁰⁹ *Id.* at 1469 (emphasis added).

The court acknowledged that Texaco Air had an ownership interest in the aircraft, but concluded that this ownership right was severely limited:

While it is true that Texaco Air was a fifty percent owner of N111QS, its ownership interest was highly fettered. To begin with, in order to purchase its interest in the first place, Texaco Air had to enter into the management agreement, the Owners Agreement, and the interchange agreement. It also had to agree that, so long as N111QS was being operated under those agreements, it would not sell or otherwise transfer its interest in the aircraft - except to an affiliate - without the prior written consent of EJS. Furthermore, any buyer had to agree to assume Texaco Air's obligations under each of the above three agreements. In addition, together the management agreement, the Owners Agreement, and the interchange agreement served to significantly restrict Texaco Air's day-to-day use of N111QS. Thus, N111QS was painted in the NetJets colors, and Texaco Air was not allowed to customize it or identify it with its corporate logo. In addition, Texaco Air incurred a surcharge when it used the aircraft for more than its allotted number of hours, and it was prohibited from using the aircraft outside of certain specified geographic areas without EJA's prior consent. Finally, EJA reserved for itself exclusive use of N111QS for its charter service and for training its pilots when the aircraft was not being used by Texaco Air and its other owners.¹¹⁰

The court agreed with the Court of Claims that the EJA program was essentially identical to a commercial air charter business. Because of the limitations of the program, EJA essentially had exclusive right to the use of the aircraft:

The Court of Federal Claims stated that it detected "negligible differences between the NetJets aircraft interchange program and the operation of a commercial air charter business." We agree. "It has been recognized that for tax purposes the substance rather than the form of a transaction is generally controlling." While it is true that Texaco Air held legal title in N111QS to the extent of its fifty percent ownership interest, the agreements which framed the NetJets program placed extensive limitations on the exercise of that interest. At the same time, EJA coordinated all of N111QS' flights with the needs of the other participants in the interchange program and reserved for itself exclusive use of the aircraft for its charter service and for training pilots when the aircraft was not being used by one of its owners. Texaco Air's highly circumscribed ownership interest in N111QS

¹¹⁰ *Id.*

simply was the vehicle through which Texaco Air entered into, and was allowed to participate in, an arrangement pursuant to which it obtained from EJA transportation from one airport to another. We hold that, through its NetJets program, *EJA was in the "business of transporting persons or property for hire by air."*¹¹¹

The court then considered and rejected EJA's final argument that Congress did not intend that the tax would apply to these kinds of flights.¹¹²

3. Critique

Both the IRS and the court held that the fractional company was providing taxable transportation services. Interestingly, they took different paths to reach the same result.

Both the IRS and the court were able to ignore the fact that the fractional company did not have an interest in the aircraft. The court relied on the "substance over form" doctrine. The IRS referred to the "totality of the circumstances."

The IRS then relied on their standard test, holding that the fractional company had "possession, command and control" of the aircraft. Interestingly, the court did not mention either "possession, command and control" or "operational control," but instead held that the fractional company was engaged in the "business of transporting persons or property for hire by air."

The decision of the court is also noteworthy in that, in contrast with the fractional rulings, the court did not hold that an owner could be taxed on the value of the use of his own aircraft.

a. Substance Over Form

Under the fractional contracts, the interest owner obtains the flight crew and the aircraft from two different sources: the pilots from the management company and the aircraft from other interest owners. Ordinarily, this would be considered dry lease of the aircraft, a nontaxable transaction.¹¹³ Both the IRS and the court ignored these legal distinctions by relying on the "substance over form" doctrine.

The "substance over form" doctrine is one of the "common law" doctrines relied on by the courts to prevent taxpayers from

¹¹¹ *Id.* (emphasis added) (citations omitted)

¹¹² *Id.* at 1470.

¹¹³ See, e.g., Rev. Rul. 68-256, 1968-1 C.B. 489 and Tech. Adv. Mem. 81-31-051 (May 8, 1981).

abusing the tax laws.¹¹⁴ However, reliance on the substance over form doctrine appears to have been unwarranted in this case.

The decision of the Supreme Court in *Frank Lyon Co. v. United States* demonstrates that there are limits on the application of the substance over form doctrine.¹¹⁵ In that case, a bank decided to build a new headquarters building, which they originally planned to finance by selling debentures. However, because of limitations imposed by banking regulations, the use of debentures was not feasible. As a result, the decision was made to sell the bank building to the taxpayer and to lease back the building. This approach was approved by the banking regulators. Following the sale, the taxpayer claimed a deduction for depreciation on the building. The IRS argued that the transaction was really a loan from the taxpayer to the bank and that the taxpayer was not the true owner of the building. Consequently, the taxpayer was not entitled to claim depreciation on the building. The case was taken to District Court, which agreed with the taxpayer. The Appellate Court reversed.¹¹⁶ The Supreme Court agreed to hear the case to resolve a conflict between the Circuits.

The Supreme Court began by discussing other cases dealing with determination of ownership of property for tax purposes and then referred to doctrine of "substance over form," stating that:

In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding."¹¹⁷

¹¹⁴ See Statement of Lindy Paull, Chief of Staff, Joint Committee on Taxation, Testimony Before the House Committee on Ways and Means, Hearing on Corporate Tax Shelters (Nov. 10, 1999) (The "common law" doctrines include "the sham transaction doctrine, the economic substance doctrine, the business purpose doctrine, the substance over form doctrine, and the step transaction doctrine").

¹¹⁵ 435 U.S. 561 (1978).

¹¹⁶ *Frank Lyon Co. v. United States*, 536 F.2d 746 (8th Cir. 1976).

¹¹⁷ *Id.* at 573 (quoting *Comm'r v. Tower*, 327 U.S. 280, 291 (1946) and *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255 (1939)).

However, upon reviewing the facts, the court concluded that the form of the transaction should govern for tax purposes:

In short, we hold that where, as here, [1] there is a genuine multiple-party transaction [2] with economic substance [3] which is compelled or encouraged by business or regulatory realities, [4] is imbued with tax-independent considerations, and [5] is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.¹¹⁸

The factors mentioned in *Frank Lyon* are also present in the typical fractional program: (1) a multi-party transaction (the owner, other interest owners and the fractional company); (2) with economic substance (reducing aircraft costs while requiring the owner to assume responsibility for risk of loss and operational control of the aircraft); (3) compelled or encouraged by business or regulatory realities (the desire to operate under FAR Part 91); (4) is imbued with tax independent considerations (same as items (2) and (3)); and (5) is not shaped by tax avoidance features (apart from wanting the same tax treatment as other Part 91 owners).

b. Business of Transporting Persons or Property for Hire by Air

The court's conclusion that the management company was "in the business of transporting persons or property for hire by air" is contrary to existing precedent.¹¹⁹ The court concluded that the statute did not require the management company to provide the aircraft. According to the court, all that was required was that the management company "use" the aircraft, citing the dictionary definition of use.¹²⁰

The court did not appear to be aware that the tax on transportation of property incorporates the same phrase and applies

¹¹⁸ *Id.* at 583-84 (bracketed numbers added).

¹¹⁹ Although the court cited the statute as referring to transportation "for compensation or hire," the court viewed the issue as involving transportation "for hire." This difference does not appear to be significant in light of the broad definition given to "for hire." *See, e.g.*, Tech. Adv. Mem. 94-41-005 (June 27, 1994) and 86-20-002 (Jan. 23, 1986).

¹²⁰ *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463, 1468 (Fed. Cir. 1997).

“only to amounts paid to a person engaged in the business of transporting property by air for hire.”¹²¹ Furthermore, the courts interpreting this language had uniformly held that, in order for a company to be engaged in the transportation business, the company must provide not only the operators, but also the equipment.

In *Bridge Auto Renting Corp. v. Pedrick*, the court was asked to determine whether amounts paid to a company that provided both the trucks and the drivers were subject to the transportation tax.¹²² The company argued that the tax did not apply because they were merely leasing the trucks to the customers. Citing the language of the statute, the court stated that:

The precise problem is whether the receipts taxed were within the meaning of the statutory language, “amounts paid [‘for transportation * * * of property’] to a person engaged in the business of transporting property for hire.”¹²³

The court identified the standard to be applied:

So it would seem that the decision here should turn upon the correct answer to an easily stated question. Did the appellant in fact *furnish substantially all the facilities for*, and perform substantially all of the functions for, transporting the property of the forty-two customers whose payments to it were taxed?¹²⁴

The court applied this “substantially all” test to hold that the company was engaged in providing transportation for hire. This same test has been applied by the courts in a number of cases as a basis for holding that a company, which provided both the equipment and operator, was engaged in the business of transporting property for hire.¹²⁵

¹²¹ I.R.C. § 4271(a) (West 2002).

¹²² *Bridge Auto Renting Corp. v. Pedrick*, 174 F.2d 733 (2d Cir. 1949), *cert. denied*, 338 U. S. 850 (1949). The court was interpreting § 3469 of the Internal Revenue Code of 1939. See discussion at II A, *supra*, for a brief history of the transportation tax.

¹²³ *Bridge Auto Renting Corp.*, 174 F.2d at 733-34.

¹²⁴ *Id.* at 737 (emphasis added).

¹²⁵ See, e.g., *Assoc. Dry Goods Corp. v. United States*, 348 F.2d 138 (2d Cir. 1965) (captive shipping company); *Earle v. Bebler*, 180 F.2d 1016 (9th Cir. 1950); *Dal-Worth Shippers Assoc., Inc. v. United States*, 211 F. Supp. 590 (N.D. Tex. 1962) (captive shipping company); *Edward Hines Lumber Co. v. United States*, 141 F. Supp. 64 (N.D. Ill. 1956); *John J. Casale, Inc. v. United States*, 86 F. Supp. 167 (Ct. Cl. 1949) (result followed where similar facts).

c. Possession, Command and Control

Although the court did not cite the possession, command and control test, a literal reading of that test also indicates that, in order for the transportation tax to apply, the same company must provide both plane and pilots. This is because, under the possession, command and control test, the person providing the pilots (or an agent of that person) must have possession *and* command *and* control of the aircraft. Conversely, where pilots are used to fly the owner's aircraft, then the owner must have relinquished possession *and* command *and* control of the aircraft. If any of these elements are lacking, then that person is not providing transportation. This is consistent with the "substantially all" test adopted by the courts, since that test requires that the person providing transportation also provide the means of transportation.

In a fractional program, the management company does not meet these requirements because, during the period the aircraft is used by an interest owner, the management company has no right to possession of the aircraft. Instead, the interest owner has possession of the aircraft during the period of use, either as a joint owner of the aircraft or as a lessee.¹²⁶ The fact that the interest owner allows the management company to use the aircraft does not mean that possession has been transferred. At most, the owner has merely given the management company a license to use the aircraft.¹²⁷ However, even this characterization is questionable, particularly since the owner is also on board the aircraft.

In the fractional rulings, the IRS conceded that the interest owner was the legal owner of the aircraft, but ignored the absence of the right to possession by asserting broadly that under the totality of the circumstances, the owners have relinquished

¹²⁶ The fact that the management company schedules the aircraft or may have possession of the aircraft between periods of use is irrelevant. The rental of a condominium is still a rental, even if a management company maintains and schedules the use of the property. The short-term rental of an automobile is still a rental, even though the rental agency has possession of the automobiles between rentals. Nor is inability to choose a particular aircraft significant. In the case of condominiums and cars, the user is required to take what is available.

¹²⁷ See, e.g., Rev. Rul. 84-4, 1984-1 C.B. 19 ("The distinction between a lease and license, as traditionally expressed, is that a lease is a conveyance of exclusive possession of specific property, for a term less than that of the grantor. MILTON R. FRIEDMAN, FRIEDMAN ON LEASES, § 37.1, at 1259 (3d ed. 1978).")

possession, command and control of the aircraft to the management company.¹²⁸

This conclusion is hard to reconcile with other transportation tax rulings. In both Rev. Rul. 74-123, which was cited as support, and Tech. Adv. Mem. 94-04-007, which was decided at the same time as the second fractional ruling, the owner had clearly relinquished operational control of the aircraft to the management company.¹²⁹ In Rev. Rul. 74-123, the IRS noted: "The company has the sole responsibility for the safe operation of Government-owned aircraft and holds the agency harmless from all claims resulting from the performance of its services."¹³⁰ In Tech. Adv. Mem. 94-04-007, the IRS noted that "the owners have given to the taxpayer . . . full operational control over the aircraft whether the air transportation is provided via charter to a third party or to an owner."¹³¹ Under these circumstances, one could easily infer an agreement to relinquish possession of the aircraft.¹³² However, in the case of a fractional agreement, the agreements clearly provide that the interest owner has "operational control" of the aircraft. Consequently, there is no language from which one could infer that the interest owner has relinquished control of the aircraft.

Perhaps the closest analogy is provided by Priv. Ltr. Rul. 7204198540A which involved a management company arrangement that was similar in operation to a fractional arrangement.¹³³ However, in that ruling, the customer leased the aircraft and obtained the flight crew from two separate, but related, companies, which caused the IRS to conclude that "the combined furnishing by [the management company] and [the leasing company] of the personnel, service *and aircraft* results in the furnishing of taxable transportation of persons by air."¹³⁴

¹²⁸ Tech. Adv. Mem. 93-14-002 (Dec. 22, 1992) and 94-04-006 (Oct. 12, 1993).

¹²⁹ Rev. Rul. 74-123, 1974-1 C.B. 318 and Tech. Adv. Mem. 94-04-007 (Oct. 20, 1993).

¹³⁰ Rev. Rul. 74-123, 1974-1 C.B. 318.

¹³¹ Tech. Adv. Mem. 94-04-007 (Oct. 20, 1993).

¹³² See also Rev. Rul. 56-608, 1956-2 C.B. 878, declared obsolete by Rev. Rul. 69-227, 1969-1 C.B. 315, where the IRS held that the transportation tax applied where "the shipper owns the tank truck equipment in which its product is transported by the carrier."

¹³³ Priv. Ltr. Rul. 7204198540A (Apr. 19, 1972).

¹³⁴ *Id.* (emphasis added). Although the customer was considered the owner of the aircraft for income tax purposes, the IRS apparently did not consider that an important factor for transportation tax purposes.

The IRS characterization of fractional programs is also hard to reconcile with the IRS characterization of similar programs. For example, in Tech. Adv. Mem. 82-41-010, the IRS considered an arrangement where the taxpayers purchased railroad boxcars and entered into a "Lease and Management Agreement" with a management company to handle the operation of boxcars operated under the railroad interchange system.¹³⁵ This required the manager to keep track of the boxcars and to handle the collection of revenues from the interchange of boxcars. The IRS was asked to consider whether the arrangement should be considered a management contract or a lease to the management company.

The IRS cited several definitions of lease, all of which involved a relinquishment of possession.¹³⁶ In deciding whether the arrangement was a management agreement, the IRS concluded that the key factors were (1) the degree of control over the venture exercised by the taxpayer/owners; and (2) the risk of loss retained by them.¹³⁷

The IRS concluded that the taxpayer had the requisite degree of control, stating that:

The first factor to be examined is which party had control of the venture. As in *Meagher*, Corp M was required to keep adequate records and supply X with such reports regarding the use of the boxcars as X may reasonably request, use reasonable efforts to integrate X's boxcars into the fleet of boxcars controlled by Corp M, obtain insurance coverage for the boxcars, and pay the net earnings of the boxcars to X within a specified period of time. Thus, the factors cited by the Tax Court in *Meagher* as indicating sufficient owner's control over the venture are present in this case.

Not only was Corp M's control of the boxcars subject to the limitations of the Agreement, but its control and possession of the boxcars were at all times subject to the rules of the interchange system. Furthermore, we believe that there has not

¹³⁵ Tech. Adv. Mem. 82-41-010 (Jun. 30, 1982).

¹³⁶ *Id.* "[A] lease is a transfer of an interest in and possession of property for a prescribed period of time in exchange for an agreed consideration, called 'rent.'" *State Nat'l Bank of El Paso v. United States*, 509 F.2d 832, 835 (5th Cir. 1975).

¹³⁷ *Id.* The IRS cited *Meagher v. Comm'r*, 36 T.C. 1091 (1977), for this conclusion. The IRS also cited *State Nat'l Bank of El Paso v. United States*, 509 F.2d 832 (5th Cir. 1975), and *Kingsbury v. Comm'r*, 65 T.C. 1068 (1976), for the statement that: "The existence of control over the venture by the property owner and a risk of loss on the property owner are key factors indicating a management contract."

been a transfer to Corp M of the right to exploit the boxcars for its own benefit. Rather, the purpose of the transfer of the cars to Corp M was to enable X to earn car hire revenues in the interchange system.¹³⁸

The IRS also concluded that the taxpayer also had the requisite risk of loss. The management company was protected from risk of loss by a “hold harmless” agreement and the insurance policy. On the other hand, the taxpayer was required to pay property taxes on the boxcars and was required to pay a management fee even if the boxcars generated no revenue.¹³⁹

Based on this analysis, the IRS concluded that the management company was merely providing a management service.

This ruling is interesting for several reasons. First, as in the case of a fractional arrangement, the ruling involves an independent interchange of property between unrelated persons not including the management company. Second, the ruling held that the property was not leased to the management company, which confirms that, in this kind of situation, the management company does not have possession of the property. Third, the ruling held that the control requirement was established by the contractual requirements that the management company maintain adequate records and obtain insurance and by the rules of the interchange system. All of these elements are present in a fractional arrangement. Furthermore, unlike the boxcar ruling, there is a chance that the interest owner will actually use his own aircraft.

d. Operational Control

While the IRS is not bound by FAA principles, *Executive Jet Aviation* appears to be the first case where the IRS and the courts held that the transportation tax applied where the user had “operational control” of the aircraft. This is unfortunate, because the “operational control” test could have provided a useful “bright line” test, particularly in the case of large civil aircraft for which the FAA “truth in leasing” rules require a written lease agreement that specifies responsibility for “operational control” of the aircraft.¹⁴⁰ Nor is assumption of “operational control” an empty gesture. The party assuming responsibility for operational control takes on liability to the FAA and to third

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ FAR 91.23.

parties. Instead, we are now left with the vague standard of whether under “the totality of the circumstances,” the person providing the pilots has “possession, command and control of the aircraft” (the IRS test) or is using the aircraft “in a business of transporting persons or property for compensation or hire by air” (the court test).

e. The Amount Paid

The fractional rulings held that the interest owner should be taxed, not only on the hourly charge, but also on the value of the use of the aircraft. However, in *Executive Jet Aviation*, the court held only that the interest owner should be taxed on the hourly charge. There is no indication that the IRS attempted to argue otherwise.

C. CONSEQUENCES AND REMAINING ISSUES

While there is room to argue with both the conclusion and the reasoning of both the IRS and the courts, neither the IRS nor the fractional companies appear to be eager to pursue the matter further. As things stand, the decision was a partial victory for both sides. The decision was a victory for the IRS because the courts held that interest owners are required to pay transportation tax on the hourly charge. The decision was a victory for the interest owners because the courts did not impose tax on the management fee or the value of the use of the aircraft. The net effect is that interest owners are required to pay more tax than other Part 91 operators, but less tax than charter customers.

While a fractional company could choose to ignore the decision of the court, this is not a practical option. If the company were wrong, the company could be held liable for the tax.¹⁴¹ It is far safer simply to collect the tax.

The biggest remaining issue has to do with the computation of hourly charges. Because the hourly charges are subject to tax and the management fees are not, fractional companies might be tempted to reclassify expenses from hourly charges to management fees. The IRS excise tax auditors are well aware of this temptation.

¹⁴¹ I.R.C. § 4263(c) (West 2002).

III. INCOME TAX ISSUES

A. THE GENERAL RULES

1. *The Income Tax*

The current version of the federal income tax was enacted as part of the Internal Revenue Code of 1986, as amended, and is codified in 26 U.S.C. 1 *et seq.* Most States also have an income tax and follow the federal principles regarding the computation of taxable income.¹⁴²

2. *Taxation of Use of Own Aircraft*

Where an aircraft is used in connection with a trade or business, a deduction is generally allowed for the costs associated with the ownership and use of the aircraft.¹⁴³ The cost of the aircraft is not currently deductible, but it is capitalized and deducted over time using the depreciation (or cost recovery) deduction.¹⁴⁴

a. The Depreciation Deduction

The law provides that “[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)” of property used in a trade or business or held for the production of income.¹⁴⁵ Prior to 1981, the amount of the “reasonable allowance” generally varied depending on the facts and circumstances of each case. In 1971, Congress attempted to reduce the uncertainty, by adding a provision allowing the use of the class life asset depreciation range (CLADR).¹⁴⁶ In 1981, Congress added the accelerated cost recovery system (ACRS), which allowed most personal property, including aircraft, to be depreciated over 5 years in accordance with a prescribed table.¹⁴⁷ In 1986,

¹⁴² In order to simplify the computation of State taxable income, most States have adopted “conformity” legislation which makes federal taxable income the starting point for computation of state taxable income.

¹⁴³ I.R.C. § 162 (West 2002). The tax laws also allow deduction of depreciation and other expenses related to the production of income. I.R.C. § 167(a)(2) and I.R.C. § 212 (West 2002), respectively. However, because of their limited application, those rules will not be discussed.

¹⁴⁴ The capitalization of costs is required by I.R.C. § 263 (West 2002). The depreciation deduction is allowed by I.R.C. § 167.

¹⁴⁵ I.R.C. § 167(a) (West 2002).

¹⁴⁶ I.R.C. § 167(m) (effective for property placed in service in 1971 and later).

¹⁴⁷ I.R.C. § 168 (West 1981) (for property placed in service and tax years ending in 1981 and later). Most personal property was considered 5-year property

Congress replaced the ACRS rules with the modified ACRS rules (MACRS) which increase the depreciation rates, the number of asset classes and the depreciation lives.¹⁴⁸

b. Tax Ownership

The person entitled to tax depreciation is referred to as the "tax owner" of the property. In general, the "tax owner" is the person who suffers an economic loss by reason of the depreciation and erosion in the value of the property.¹⁴⁹ In most cases, the tax owner is the legal owner of the property.

These principles have been applied to determine tax ownership in the context of a lease. In the case of an ordinary "operating lease," the lessor is considered the tax owner of the property. However, in the case of a "financing lease" the lessee is considered the tax owner. In effect, a financing lease is treated as a sale of the property to the lessee, financed by the lessor. For example, in *Helvering v. F & R Lazarus & Co.*, the Supreme Court held that the lessee was the tax owner, stating that:

While it may more often be that he who is both owner and user bears the burden of wear and exhaustion of business property in the nature of capital, one who is not the owner may nevertheless bear the burden of exhaustion of capital investment. Where it has been shown that a lessee using property in a trade or business must incur the loss resulting from depreciation of capital he has invested, the lessee has been held entitled to the statutory deduction.¹⁵⁰

In *Grodts & McKay Realty v. Comm'r*,¹⁵¹ the Tax Court listed eight factors which have been used by the courts to determine whether a purported sale has resulted in a transfer of tax ownership:

(1) Whether legal title passes . . . ; (2) how the parties treat the transaction . . . ; (3) whether an equity was acquired in the property . . . ; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments . . . ; (5) whether the right of

pursuant to the rules prescribed in I.R.C. § 168(c)(2) (West 1981). As prescribed by I.R.C. § 168(b)(1) (West 1981), the depreciation deductions for each of the five years were 15%, 22%, 21%, 21% and 21%, respectively.

¹⁴⁸ I.R.C. § 168 (West 2002).

¹⁴⁹ See, e.g., *Weiss v. Weiner*, 279 U.S. 333 (1929).

¹⁵⁰ *Helvering v. F & R Lazarus & Co.*, 308 U.S. 252, 254 (1939).

¹⁵¹ *Grodts & McKay Realty v. Comm'r*, 77 T.C. 1221 (1981).

possession is vested in the purchaser . . . ; (6) which party pays the property taxes . . . ; (7) which party bears the risk of loss or damage to the property . . . ; and (8) which party receives the profits from the operation and sale of the property. ¹⁵²

c. Class Life

Under the MACRS rules, the recovery period is determined by reference to the class life of the property.¹⁵³ The class life is determined by reference to the CLADR rules.¹⁵⁴ In the case of aircraft, the class life will vary depending on whether the aircraft falls into asset class 00.21 or asset class 45.

Asset class 00.21 includes “airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines).”¹⁵⁵ Aircraft and helicopters included in asset class 00.21 have a class life of 6 years.¹⁵⁶ Property with a class life of 6 years is considered 5-year property,¹⁵⁷ which has a recovery period of 5 years.¹⁵⁸

Asset class 45 is entitled “Air Transport” and includes “assets (except helicopters) used in commercial and contract carrying of passengers and freight by air.”¹⁵⁹ Aircraft included in asset class 45 have a class life of 20 years.¹⁶⁰ Property with a class life of 12 years is considered 7-year property,¹⁶¹ which has a recovery period of 7 years.¹⁶²

¹⁵² *Id.* at 1237 (citations omitted). In some cases, the seller of property is still be considered to be the tax owner, particularly where there is a repurchase option which protects the purchaser from risk of loss. *See, e.g.*, Rev. Rul. 83-47, 1983-1 CB 63 (“Investors are not entitled to deductions under the accelerated cost recovery system for townhouses that are purchased and immediately leased back with the stipulation that they will be resold to the original seller a year and a day following the original sale at a predetermined price.”).

¹⁵³ I.R.C. § 168(c), (e)(1) (West 2002).

¹⁵⁴ I.R.C. § 168(i)(1) (West 2002) provides, *inter alia*, that: “the term ‘class life’ means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167.”

¹⁵⁵ Rev. Proc. 87-56, 1987-2 C.B. 674.

¹⁵⁶ *Id.*

¹⁵⁷ I.R.C. § 168(e)(1) (West 2002).

¹⁵⁸ I.R.C. § 168(c) (West 2002).

¹⁵⁹ Rev. Proc. 87-56, 1987-2 CB 674.

¹⁶⁰ *Id.*

¹⁶¹ I.R.C. § 168(e)(1) (West 2002).

¹⁶² I.R.C. § 168(c) (West 2002).

In general, aircraft operated under Part 91 are considered to fall in asset class 00.21 while aircraft operated under Part 135 are considered to fall under asset class 45.¹⁶³

3. *Taxation of Joint Ownership Agreement*

In general, the income tax laws treat the joint owner of property as the tax owner of their share of the property. This means that each of the joint owners of an aircraft is entitled to deduct the depreciation and other expenses relating to their share of the aircraft.¹⁶⁴

In some cases, a joint ownership arrangement will be considered to be a joint venture or partnership.¹⁶⁵ However, the partnership regulations provide that mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership.¹⁶⁶

4. *Taxation of Dry Lease Exchange*

There do not appear to be any cases or rulings specifically addressing the taxation of a dry lease exchange.

An undertaking by several taxpayers to contribute and share property using offsetting leases does not appear to create taxable income. Such an undertaking does not create a separate entity for federal tax purposes.¹⁶⁷ Furthermore, the sharing of the use of property does not appear to create a taxable "accession to wealth."¹⁶⁸

¹⁶³ Where an aircraft is operated under both Part 91 and Part 135, the CLADR rules provide that the asset class shall be determined by considering the primary use of the property during the first tax year of service. See Treas. Reg. 1.167-(a)-11(b)(4)(iii)(b) (2002).

¹⁶⁴ See, e.g., Priv. Ltr. Rul. 88-20-010 (Feb. 10, 1998) (depreciation deduction of joint owner of a power plant); Priv. Ltr. Rul. 86-32-039 (May 13, 1986) (depreciation deduction of joint owners of nuclear-fueled generation facility).

¹⁶⁵ I.R.C. § 7701(a)(2) (West 2002) provides that "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."

¹⁶⁶ Treas. Reg. § 1.761-1(a) (2002); Rev. Rul. 75-374, 1975-2 C.B. 261.

¹⁶⁷ Treas. Reg. § 301.7701-1(a)(2) (2002) ("a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes").

¹⁶⁸ See, e.g., Priv. Ltr. Rul. 2001-10-022 (Dec. 7, 2000) ("Gross income includes income realized in any form, whether in money, property, or services. Section 1.61-1(a) of the Income Tax Regulations. This definition encompasses all 'accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.'") (quoting *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)).

The use of the dry lease exchange should not affect the depreciation deduction. The owner of an aircraft which is leased to others can claim depreciation in the same manner as any other owner.¹⁶⁹ For purposes of determining class life, the CLADR rules provide that “the asset guideline class for such property shall be determined as if the property were owned by the lessee.”¹⁷⁰ For example, if the lessee primarily uses the aircraft to provide commercial transportation, then the aircraft would be considered “Air Transport” property.

B. CHARACTERIZATION OF FRACTIONAL PROGRAMS

1. *In General*

There have not been any cases or rulings characterizing fractional programs for federal income tax purposes. The prevailing practice appears to be to characterize the fractional program as involving the purchase of a capital interest in an aircraft along with separate payments for operating costs and management services. The dry lease exchange is ignored.

2. *The Depreciation Deduction*

The decision of the court in *Executive Jet Aviation* has raised some concerns that, for income tax purposes, the fractional interest owner might not be considered the owner of an aircraft or that the aircraft cannot be depreciated using a 5-year recovery period. However, a close review of the case indicates that these concerns are unfounded.

a. Tax Ownership

At the outset, it should be noted that that someone has to be the tax owner of the aircraft. As compared to all the other possible candidates (e.g. the seller, the management company and the other participants), there are a number of compelling reasons why the interest owner should be considered the tax owner.

First, under the fractional program documents, the interest owner is clearly considered the owner of the aircraft for FAA and commercial purposes. As discussed in connection with the transportation tax, the Supreme Court in *Frank Lyon Co. v. United States* indicated that the characterization of a transaction

¹⁶⁹ See, e.g., Rev. Rul. 80-127, 1980-1 C.B. 53 (lessor of shipping containers entitled to deduct depreciation).

¹⁷⁰ Treas. Reg. § 1.167-(a)-11(e)(3)(iii) (2002).

should be respected as long as the transaction has economic substance and a valid business purpose.¹⁷¹ And, as previously discussed, the fractional program clearly meets those requirements. The *Frank Lyon* case has particular application here because the question in that case was also one of tax ownership.

Second, as compared to all the other possible tax owners, the interest owner is the one with the greatest risk of loss. If there is a decline (or increase) in the value of the aircraft, the interest owner is the one who will suffer (or profit) from that change.

The conclusion that the interest owner is the tax owner is further supported by Tech. Adv. Mem. 82-41-010, relating to boxcars used in the railroad interchange system.¹⁷² In that ruling, the owner of the boxcars was claiming depreciation on the boxcars and no objection was raised to that treatment. To the contrary, the ruling held that the owner was entitled to claim investment credit, further proof of tax ownership.

The court in *Executive Jet Aviation* said nothing which would indicate that the interest owner should not be considered the tax owner. The conclusion of the court that the management company (EJA) was providing transportation has no impact on the question of tax ownership because a person can be the provider of taxable air transportation and still not be the tax owner of the aircraft.¹⁷³ Furthermore, the court specifically rejected the notion that the management company was the owner or lessor of the aircraft, "We reject EJA's argument that it was necessary for it to provide aircraft to Texaco Air by being an owner or lessor in order for Texaco Air's flights under the NetJets program to be subject to the transportation tax."¹⁷⁴ At most, the court concluded that the management company was merely "using" the aircraft in their transportation business - which, without more, is not enough to switch tax ownership away from the interest owner.

b. Class Life

The question of class life is a closer question. The court in *Executive Jet Aviation* indicated that the management company used the aircraft "in a business of transporting persons or prop-

¹⁷¹ *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

¹⁷² Tech. Adv. Mem. 82-41-010 (Jun. 30, 1982).

¹⁷³ For example, a charter company might use aircraft leased from another company which is the tax owner of the aircraft.

¹⁷⁴ *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463, 1468 (Fed. Cir. 1997).

erty for compensation or hire by air.” Under the MACRS rules, an aircraft which is primarily used in commercial and contract carrying of passengers and freight by air is considered “air transport” property.¹⁷⁵ On the surface, the similarity in language strongly suggests that fractional aircraft should be considered air transport property. However, a close review of the case does not support this conclusion.

Where property is leased, the CLADR rules provide that the lessee is considered to be the user of the property. Under the fractional agreements, the aircraft is leased to the other fractional participants. The court in *Executive Jet Aviation* said nothing which would indicate that the participants are not the lessees. Since these participants are contractually prohibited from using the aircraft to provide “commercial transportation,” the aircraft should not be classified as “air transport” property.

The fact that the court in *Executive Jet Aviation* held that the management company was using the aircraft should not undermine this conclusion because the term “use” was defined in the broadest possible sense, as “the act or practice of using something.”¹⁷⁶ Thus, while the court could say that the management company was using the aircraft, the same could be said of the lessee and everyone else on board the aircraft. Under these circumstances, the CLADR rules indicate that the class life should be determined by reference to the lessee use.

C. CONSEQUENCES AND REMAINING ISSUES

1. Tax Depreciation

As long as the interest owner has the risk of loss of value on the resale of the aircraft, the tax owner should be considered the tax owner of the aircraft and should be entitled to claim the depreciation deduction on the aircraft. To date, the IRS has not challenged the depreciation of the aircraft by the owner or the use of the 5-year class life.¹⁷⁷

¹⁷⁵ Rev. Proc. 87-56, 1987-2 C.B. 674.

¹⁷⁶ *Executive Jet Aviation*, 125 F.3d at 1468 (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2523 (3d ed. 1986)).

¹⁷⁷ The IRS may have practical reasons for not challenging this treatment. First, if the IRS were to successfully challenge the owner's right to claim depreciation, the likely result is that the fractional company would be entitled to claim depreciation (albeit under the 7-year class life). This would lead to a net revenue loss because the fractional company would be able to depreciate all of the aircraft while, under the existing rules, not every owner is claiming depreciation on their aircraft. Second, if the IRS were to rely on *Executive Jet Aviation* to argue that the

2. *Dry Lease Exchange*

The use of the dry lease exchange does not appear to create any other tax issues. First, although the IRS has indicated in the transportation tax rulings that a "wet lease" interchange is "essentially a barter exchange,"¹⁷⁸ there is nothing to indicate that the dry lease exchange should be considered a barter exchange for income tax purposes.¹⁷⁹ In contrast with a taxable barter exchange, a dry lease exchange does not involve a taxable "accession to wealth," but merely an allocation of usage which has already been paid for.¹⁸⁰ Second, although the aircraft is being leased to third parties, the passive activity loss (PAL) rules do not appear to apply since the lease is not, in itself, a trade or business.¹⁸¹

3. *Administrative Issues*

The fractional programs do create some unique administrative issues. For example, where an employee uses a company aircraft for personal travel, the imputed income rules require an amount to be included in income, which can vary depending on

fractional aircraft are "air transport" property and lost, then fractional companies might be encouraged to relitigate the transportation tax issue.

¹⁷⁸ See, e.g., Tech. Adv. Mem. 95-02-004 (Sept. 6, 1994).

¹⁷⁹ The conclusion that the dry lease exchange is a taxable barter exchange would not have an impact on a business owner since any barter income would be offset by barter expense. Instead, the conclusion might have an impact on a non-business owner if that owner were prohibited from offsetting barter income with barter expenses. Also, the fractional company might be required to report the barter transactions pursuant to I.R.C. § 6045 (West 2002).

¹⁸⁰ See, e.g., *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (holding that punitive damages received by the taxpayer were taxable because they were, inter alia "undeniable accessions to wealth"). The conclusion that there is no taxable barter exchange is further supported by a review of the barter exchange reporting rules. I.R.C. § 6045 requires the reporting of barter transactions. I.R.C. § 6045(c) defines a barter exchange as "any organization of members providing property or services who jointly contract to trade or barter such property or services." In a fractional program, there is no exchange of property or services, merely the exchange of the use of property. Finally, a barter exchange involves an accounting for the value of property or services provided in order to insure that the contributor is properly compensated. However, in the case of a fractional program, there is no accounting for the value of the use of the aircraft.

¹⁸¹ The PAL rules were intended to prevent taxpayers from offsetting earned income with losses from passive "tax shelters." I.R.C. § 469(c)(1) (West Supp. 2002) defines a "passive activity" as any activity which, inter alia, "involves the conduct of any trade or business." In a fractional program, the lease is not a separate trade or business, but is simply a mechanism for sharing aircraft with other owners.

the type of aircraft used.¹⁸² In a fractional program, the type of aircraft can vary from trip to trip.

IV. STATE TAXATION OF FRACTIONAL PROGRAMS

A. BACKGROUND

In addition to the State income tax, there are a wide variety of State taxes which apply to aircraft, the most significant of which are the sales and use tax and the property and/or registration tax.

The sales tax is a one-time tax on the sale of taxable property or services in the State. The use tax, which is intended as a "backstop" to the sales tax, is a one-time tax on the use of taxable property or services in the State. The tax amount is generally a percentage of the sales or purchase price.

The property tax is an annual tax on property located in the State. The tax amount is generally a percentage of the value of the property. The registration tax is annual tax on the use of an aircraft in the State. The registration tax is generally imposed "in lieu of" the property tax. The tax amount may be based on any number of factors, including the weight of the aircraft.

B. FEDERAL LIMITATIONS ON STATE TAX

When Airport and Airway Revenue Act of 1970 was enacted, Congress created an Airport and Airways Trust Fund which was to be funded by the federal transportation tax and the fuel tax.¹⁸³ In *Evansville-Vanderburgh Airport Authority District v. Delta Airlines*, the Supreme Court held that a State could also impose a head tax on air transportation.¹⁸⁴ In response, Congress enacted the "Anti-Head Tax Act" as part of The Airport Development Acceleration Act of 1973.¹⁸⁵ This Act prohibits the imposition of a "tax, fee, head charge, or other charge" on an individual traveling in air commerce, the transportation of an individual traveling in air commerce, the sale of air transportation, or the gross receipts from that air commerce or transporta-

¹⁸² See generally 26 C.F.R. §§ 1.61-21(b)(6), (7) (general valuation rule considers charter value of aircraft) and 26 C.F.R. § 1.61-21(g)(7) (special valuation rule considers maximum certified takeoff weight of the aircraft).

¹⁸³ Pub. L. No. 91-258, 84 Stat. 219.

¹⁸⁴ *Evansville-Vanderburgh Airport Auth. Dist. v. Delta Airlines*, 405 U.S. 707 (1972).

¹⁸⁵ Pub. L. No. 93-44, 87 Stat. 90 (as amended, reenacted, and recodified at 49 U.S.C. § 40116).

tion.¹⁸⁶ In *Aloha Airlines, Inc. v. Director of Taxation*, the Supreme Court held that the Anti-Head Tax Act prohibited the imposition of a gross receipts tax on airlines, even where that tax was "disguised" as a property tax.¹⁸⁷ Other State court cases have held that the Act prohibits the imposition of a variety of State taxes, including privilege taxes.¹⁸⁸

In the Airport and Airway Improvement Act of 1982, Congress amended the Airway Development Acceleration Act of 1973, by prohibiting the importing of discriminatory property taxes on air carriers.¹⁸⁹ This was later upheld by the Supreme Court in *Western Air Lines, Inc. v. Board of Equalization*.¹⁹⁰

C. CONSTITUTIONAL LIMITATIONS

The two primary federal constitutional limitations on the State taxation of aircraft are the "Due Process Clause" and the "Commerce Clause." The Due Process Clause provides that no State shall "deprive any person of life, liberty, or property, without due process of law."¹⁹¹ The Commerce Clause states that: "The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."¹⁹²

The test most commonly applied to determine whether a tax is constitutional was first enunciated by the Supreme Court in *Complete Auto Transit, Inc. v. Brady*.¹⁹³ This case significantly changed the rules applicable to the State taxation of aircraft.

¹⁸⁶ 49 U.S.C. § 40116(b) provides that:

Except as provided in subsection (c) of this section and section 40117 of this title, a State, a political subdivision of a State, and any person that has purchased or leased an airport under section 47134 of this title may not levy or collect a tax, fee, head charge, or other charge on -

- (1) an individual traveling in air commerce;
- (2) the transportation of an individual traveling in air commerce;
- (3) the sale of air transportation; or
- (4) the gross receipts from that air commerce or transportation.

¹⁸⁷ *Aloha Airlines, Inc. v. Dir. of Taxation*, 464 U.S. 7 (1983).

¹⁸⁸ See, e.g., *Arizona Dep't of Revenue v. Cochise Airlines*, 626 P.2d 596 (Ariz. Ct. App. 1980) (transaction privilege tax); *Republic Airlines, Inc. v. State*, 427 N.W.2d 182 (Mich. Ct. App. 1988) (single business tax).

¹⁸⁹ Pub. L. No. 97-248, 96 Stat. 324, 671 (1982) (originally codified as 49 U.S.C. § 1513(d); later codified as 49 U.S.C. § 40116(d)).

¹⁹⁰ *Western Air Lines, Inc. v. Bd. of Equalization*, 480 U.S. 123 (1987).

¹⁹¹ U.S. CONST. amend. XIV, § 1.

¹⁹² U.S. CONST. art. I, § 8.

¹⁹³ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

The impact of this case can be demonstrated by a review of the case law.

1. *The Due Process Clause and the "Nexus" Requirement*

The current formulation of the "nexus" requirement was first stated by Supreme Court in *Miller Bros. Co. v. Maryland*.¹⁹⁴ Miller Brothers was a merchandising company which operated a retail store in Delaware. Some of the customers who purchased items at the store were from Maryland and asked the company to ship the items to them. In some cases, these items were shipped to the customer by common carrier, and in other cases, the items were delivered to the customer by a company truck. Maryland law imposed a use tax on these kinds of articles. Maryland argued that Miller Brothers should be required to collect Maryland use tax on the articles shipped into Maryland.

The court reviewed their prior decisions and concluded that, "the course of decisions does reflect at least consistent adherence to one time-honored concept: that *due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.*"¹⁹⁵ The court concluded that the activities of Miller Brothers did not create the kind of link or connection necessary to justify Maryland's imposition of the obligation to collect use tax.

In later cases, this test became referred to as the "nexus" test.¹⁹⁶ These cases also indicated that one of the primary issues in a Due Process case is "whether the state has given anything for which it can ask return."¹⁹⁷

2. *The Property Tax Cases and the "Situs" Requirement*

The modern rules relating to property taxation can be traced back over a century, to when the taxation of railroad equipment became an issue. In *Pullman's Palace-Car Co. v. Pennsylvania*, the Supreme Court held that an apportioned property tax could be imposed on instrumentalities of interstate commerce.¹⁹⁸ The

¹⁹⁴ *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954).

¹⁹⁵ *Id.* at 344-45 (emphasis added).

¹⁹⁶ See, e.g., *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967); *Scripto v. Carson*, 362 U.S. 207 (1960).

¹⁹⁷ *Nat'l Bellas Hess*, 386 U.S. at 756.

¹⁹⁸ *Pullman's Palace-Car Co. v. Pennsylvania*, 141 U.S. 18 (1891). See also *Union Refrigerator Transit Co. v. Kentucky*, 199 U.S. 194 (1905) (holding that a state may not assess taxes against property which has acquired a taxable situs outside of the State).

Court reasoned that a State has the right to tax any personal property found within its jurisdiction, whether that property is engaged in intrastate or interstate commerce.¹⁹⁹

In *Northwest Airlines v. Minnesota*, the Supreme Court first considered a case involving the taxation of aircraft.²⁰⁰ In that case, Northwest Airlines, which was domiciled in Minnesota, sought to exclude some aircraft from tax. The Court held that Minnesota, as the domicile State, had the power to tax all aircraft entering the State.²⁰¹

In *Ott v. Mississippi Valley Barge Line Co.*,²⁰² the Supreme Court held that Louisiana could impose an apportioned property tax on barges engaged in interstate commerce on the Mississippi River, observing that:

We see no practical difference so far as either the Due Process Clause or the Commerce Clause is concerned whether it is vessels or railroad cars that are moving in interstate commerce. The problem under the Commerce Clause is to determine 'what portion of an interstate organism may appropriately be attributed to each of the various states in which it functions.' So far as due process is concerned the only question is whether the tax in practical operation has relation to opportunities, benefits, or protection conferred or afforded by the taxing State. Those requirements are satisfied if the tax is fairly apportioned to the commerce carried on within the State.²⁰³

In *Braniff Airways, Inc. v. Nebraska State Board of Equalization*, the Supreme Court held that Nebraska could impose an apportioned tax on the Braniff fleet, even though Braniff was not domiciled in Nebraska.²⁰⁴ Braniff argued that Nebraska could not impose a property tax because the property had not acquired a "taxable situs" in the State, and hence the tax imposed a burden on interstate commerce. The Court rejected this position, observing that the "situs" issue was a Due Process issue, not a Commerce Clause issue.²⁰⁵ The court then stated that:

¹⁹⁹ Pullman's Palace-Car Co. v. Pennsylvania, 141 U.S. at 25-26.

²⁰⁰ Northwest Airlines v. Minnesota, 322 U.S. 292 (1944).

²⁰¹ *Id.* at 303.

²⁰² Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169 (1949).

²⁰³ *Id.* at 174 (citations omitted).

²⁰⁴ Braniff Airways, Inc. v. Nebraska State Board of Equalization, 347 U.S. 590 (1954).

²⁰⁵ *Id.* at 598-99 ("While the question of whether a commodity en route to market is sufficiently settled in a state for purpose of subjection to a property tax has been determined by this Court as a Commerce Clause question, the bare

Thus the situs issue devolves into the question of whether eighteen stops per day by appellant's aircraft is sufficient contact with Nebraska to sustain that state's power to levy an apportioned ad valorem tax on such aircraft. We think such regular contact is sufficient to establish Nebraska's power to tax even though the same aircraft do not land every day and even though none of the aircraft is continuously within the State. The basis of the jurisdiction is the habitual employment of the property within the State.²⁰⁶

In *Central Railroad Co. v. Pennsylvania*, the Supreme Court held a domiciliary state could not impose an unapportioned tax on railroad cars which had acquired a tax situs in another State.²⁰⁷ The court listed two situations where such situs might exist: (1) where the property travels through the State along "fixed and regular routes;"²⁰⁸ or (2) where the property is "habitually employed" in the State.²⁰⁹

Taken together, these Supreme Court decisions indicate the Constitution prohibits a nondomiciliary State from imposing a property tax on an aircraft, or a fleet of aircraft, unless the aircraft, or the fleet of aircraft, have acquired a "situs" with that State. Situs may exist where (1) the aircraft is flown on fixed and regular routes in the State, or (2) the aircraft is habitually employed in the State.

And, despite the Court's analysis in *Braniff Airways* of "situs" as a Due Process issue, *Central Railroad Co.*, *Ott*, and *Northwest Airlines* indicate that the Court considers situs to be a Commerce Clause issue as well.²¹⁰

question whether an instrumentality of commerce has tax situs in a state for the purpose of subjection to a property tax is one of due process.").

²⁰⁶ *Id.* at 600-01.

²⁰⁷ *Cent. R.R. Co. v. Pennsylvania*, 370 U.S. 607 (1962).

²⁰⁸ *Id.* at 614 ("Had the record shown that appellant's cars traveled through other States along fixed and regular routes, even if it were silent with respect to the length of time spent in each nondomiciliary State, it would doubtless follow that the States through which the regular traffic flowed could impose a property tax measured by some fair apportioning formula.").

²⁰⁹ *Id.* at 615 ("Alternatively a nondomiciliary tax situs may be acquired even if the rolling stock does not follow prescribed routes and schedules in its course through the nondomiciliary State. . . . Habitual employment within the State of a substantial number of cars, albeit on irregular routes, may constitute sufficient contact to establish a tax situs permitting taxation of the average number of cars so engaged.").

²¹⁰ *Cent. R.R. Co. v. Pennsylvania*, 370 U.S. at 611 ("Since [*New York Central R. Co. v. Miller*] this Court has decided numerous cases touching on the intricate problems of accommodating, under the Due Process and Commerce Clauses, the taxing powers of domiciliary and other States with respect to the instrumentali-

State court decisions indicate that, at least as far as the States are concerned, situs requires a fairly substantial presence. For example, in *Peabody Coal Co. v. State Tax Commission*, a Missouri-based corporation argued that they should be entitled to a reduction of Missouri property tax because their aircraft had acquired a situs in Indiana.²¹¹ One aircraft made 19.1% of its landings there and the other 31.8%. In refusing to allow apportionment, the court noted that:

Here, for all the stipulation shows, the taxpayer used the two planes for travel to Indiana and other states without any regularity and solely in accordance with the requirements of its business. There is neither the daily scheduling of *Braniff* nor the habitual employment of *Central Railroad*. Property does not become subject to multiple taxation simply because it is often taken across a State line. *Central Railroad, supra*, provides more support for the State than for the taxpayer, by allowing unapportioned taxation of most of the classes of railroad car discussed.

To acquire an "actual situs" in another State so as to limit the exclusive taxing authority of the home State, there must be "continuous presence in another state which thereby supplants the home state and acquires the taxing power over personality that has become a permanent part of the foreign state." Peabody has not met its burden of showing a continuous presence or "actual situs" in Indiana.²¹²

In other words, the court appeared to be saying that only an airline making regularly scheduled flights into a State could meet the situs requirement and that even a charter airline might have trouble qualifying for apportionment.²¹³

ties of interstate commerce."); *Ott v. Mississippi Valley Barge Line Co.*, 336 U. S. at 174 ("We see no practical difference so far as either the Due Process Clause or the Commerce Clause is concerned whether it is vessels or railroad cars that are moving in interstate commerce."); *Northwest Airlines v. Minnesota*, 322 U.S. at 300 (affirming that "neither the Commerce Clause nor the Fourteenth Amendment affords . . . constitutional immunity" against taxation in either the domiciliary State or another State where situs is established).

²¹¹ *Peabody Coal Co. v. State Tax Comm'n*, 731 S.W.2d 837, 838 (Mo. 1987).

²¹² *Id.* at 839 (quoting *Northwest Airlines*, 322 U.S. at 296).

²¹³ In *Steuart Transp. Co. v. District of Columbia*, Op. No. 1035 (D.C. Tax Ct. 1964), the court held that barges did not have situs in the District, noting that "the use of the waterways of the District was habitual and continuous, but not regular." See also *Billings Transfer Corp. v. County of Davidson*, 170 S.E.2d 873, 884 (N.C. 1969) ("It was incumbent upon plaintiff to show that a defined portion of its property was operated along fixed routes and on regular schedules into, through, and out of nondomiciliary states or was habitually situated and employed in other states throughout the tax year."). In *Jet Fleet Corp. v. Dallas County Appraisal District*, 773 S.W. 2d 744 (Tex. Ct. App. 1988), the court held that char-

In fact, this is precisely where the line has been drawn by the laws of most States. State laws generally require apportionment in the case of an airline company.²¹⁴ All other aircraft, including charter aircraft and Part 91 aircraft, are typically subject to property tax only in the State where the aircraft is based.²¹⁵

3. *The Commerce Clause and the "Taxable Moment"*

Prior to the Supreme Court's decision in *Complete Auto Transit*, there were several different points of view regarding the taxability of instrumentalities of interstate commerce. In cases such as *Western Live Stock v. Bureau of Revenue*, the Court expressed the philosophy that interstate commerce could be made to pay its own way.²¹⁶ In other cases, the Court indicated that there were limits on the ability of the States to tax the instrumentalities of interstate commerce. In *Helson & Randolph v. Kentucky*,²¹⁷ the Court ruled that a fuel tax was an unconstitutional burden on interstate commerce, observing that:

ter aircraft had not acquired a situs outside of Texas where the aircraft was parked and maintained more than 80% of the time in Texas and more than 50% of the fuel was purchased in Texas.

²¹⁴ See, e.g., CAL. REV. & TAX. CODE § 1150 *et seq.* (West 2001) (provides for apportionment of value of "aircraft operated by an air carrier or foreign air carrier engaged in air transportation"); TENN. CODE ANN. §§ 67-5-1301 *et seq.* (Michie 2001) (provides for apportionment of value of property of "[c]ommercial air carrier companies holding a certificate of convenience and necessity from the comptroller, civil aeronautics board, federal aviation administration or any other federal or state regulatory agency excepting those companies whose operations are solely chartered operations."); WASH. REV. CODE §§ 84.12.200 *et seq.* (West 2001) (provides for apportionment of value of property of an "airplane company" "engaged in the business of transporting persons and/or property for compensation"). The apportionment process is generally handled at the State level, rather than the local level.

²¹⁵ As a practical matter, most States have a vested interest in not trying to tax non-resident aircraft. The only way to tax non-resident aircraft would be to lower the "situs" bar. Although a lower bar might allow the States to tax more non-resident aircraft, it would also allow more resident aircraft to qualify for apportionment. At best, the States would have to do a lot more work simply to get to the same result. But the more likely answer is that, given the relative resources of the local governments and taxpayers the States would end up losing more than they gained.

By way of comparison, in States where the laws have been amended to allow apportionment of resident charter or business aircraft, such as Missouri, Nevada and Texas, the tax authorities have become more aggressive in attempting to tax non-resident aircraft.

²¹⁶ *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938).

²¹⁷ *Helson & Randolph v. Kentucky*, 279 U.S. 245 (1929).

The tax is exacted as the price of the privilege of using an instrumentality of interstate commerce. It reasonably cannot be distinguished from a tax for using a locomotive or a car employed in such commerce. A tax laid upon the use of the ferryboat would present an exact parallel. And is not the fuel consumed in propelling the boat an instrumentality of commerce no less than the boat itself? A tax which falls directly upon the use of one of the means by which commerce is carried on directly burdens that commerce. If a tax cannot be laid by a state upon the interstate transportation of the subjects of commerce, as this Court definitely has held, it is little more than repetition to say that such a tax cannot be laid upon the use of a medium by which such transportation is effected.²¹⁸

This same kind of sentiment was expressed in a number of other decisions.²¹⁹

Although these cases indicated that the instrumentalities of interstate commerce were exempt from tax, other decisions indicated that these instrumentalities could be taxed if there was a "taxable moment" where they were not engaged in interstate commerce. For example, in *Southern Pacific Co. v. Gallagher*, the court held that railroad rolling stock could be taxed if there was a "taxable moment" where the instrumentality was not in interstate commerce.²²⁰

In 1969, the Maryland Court of Appeals held in *W.R. Grace & Co. v. Comptroller* that the Commerce Clause prohibited the imposition of Maryland use tax on two business aircraft which were owned by a Maryland-based business, but used exclusively in interstate commerce.²²¹ In that case, W. R. Grace had taken delivery of both aircraft outside of Maryland and, thereafter, the aircraft were used "regularly and exclusively in transporting property and passengers, primarily executives and customers of Grace, across state lines and national boundaries to various Grace plants throughout the continent."²²² The court quoted from the decision of the Supreme Court in *Michigan-Wisconsin Pipe Line Co. v. Calvert*, "It is now well settled that a tax imposed

²¹⁸ *Id.* at 252.

²¹⁹ See, e.g., *Michigan-Wisconsin Pipe Line Co. v. Calvert*, 347 U.S. 157 (1954); *Freeman v. Hewit*, 329 U.S. 249 (1946); *Cooney v. Mountain States Tel. & Tel. Co.*, 294 U.S. 384 (1935). See also *Spector Motor Serv. v. O'Connor*, 340 U.S. 602 (1951) (holding that a State could not impose a privilege tax on any portion of the income of a corporation engaged exclusively in interstate commerce).

²²⁰ *Southern Pac. Co. v. Gallagher*, 306 U.S. 167, 177 (1939).

²²¹ *W. R. Grace & Co. v. Comptroller*, 258 A.2d 740 (Md. 1969).

²²² *Id.* at 742 (quoting from the opinion of the lower court).

on a local activity related to interstate commerce is valid if, and only if, the local activity is not such an integral part of the interstate process, the flow of commerce, that it cannot realistically be separated from it.”²²³

The court recognized that in *Southern Pacific Co.*, the Supreme Court had previously upheld the imposition of a California use tax on railroad rolling stock, stating that, “We think there was a *taxable moment* when the former had reached the end of their interstate transportation and had not begun to be consumed in interstate operation.”²²⁴ However, the Maryland Court concluded that, in this case, there was not a “taxable moment” and that the Maryland use tax could not be imposed.

Not surprisingly, this same issue was raised in several more States over the next eight years. However, in all of those cases, the courts either disagreed with the Maryland Court or were able to find that a “taxable moment” had occurred which removed the aircraft from the protection of the Commerce Clause.²²⁵

4. *Complete Auto Transit*

In *Complete Auto Transit v. Brady*, the Supreme Court was asked to review the constitutionality of a Mississippi privilege tax on a company engaged in the business of transporting motor vehicles by motor carrier for General Motors Corporation.²²⁶

The Court held that the Commerce Clause did not prohibit imposition of a privilege on an interstate business, rejecting their prior decision in *Spector Motor Service v. O'Connor*, which had held to the contrary.²²⁷ In reaching this conclusion, the

²²³ Id. at 745 (quoting *Michigan-Wisconsin Pipe Line Co. v. Calvert*, 347 U. S. at 166).

²²⁴ Id. (quoting *Southern Pac. Co. v. Gallagher*, 306 U.S. at 177) (emphasis added).

²²⁵ See, e.g., *Aspen Airways, Inc. v. Heckers*, 499 P.2d 636 (Colo. Ct. App. 1972); *Sundstrand Corp. v. Dep't of Revenue*, 339 N.E.2d 351 (Ill. App. Ct. 1976); *In re Protest of Woods Corp.*, 531 P.2d 1381 (Okla. 1975) (also holding that the aircraft had not become an instrumentality of interstate commerce); *Vector Co., Inc. v. Benson*, 491 S.W.2d 612 (Tenn. 1973).

Interestingly, the only court to agree with the Maryland court was the Missouri Supreme Court, in *Director of Revenue v. L&L Marine Service, Inc.*, 647 S.W.2d 524 (Mo. 1983), which was decided six years after *Complete Auto Transit* and did not mention either case. Four years later, the Missouri Supreme Court, in *Director of Revenue v. Superior Aircraft Leasing Co.*, 734 S.W.2d 504 (Mo. 1987), overruled this decision, relying on *Complete Auto Transit*.

²²⁶ *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

²²⁷ *Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951).

Court reviewed their prior decisions and concluded that these decisions:

have considered not the formal language of the tax statute but rather its practical effect, and have sustained a tax against Commerce Clause challenge when the tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.²²⁸

This four-part test later became known as the "Complete Auto Transit Test" and has been used to determine the constitutionality of various State taxing schemes, including State sales and use taxes,²²⁹ State property taxes,²³⁰ and State income taxes.²³¹ The Court has also made certain refinements to the test, none of which appear to have application to the present analysis.²³²

The decision in *Complete Auto Transit* has had several important consequences relating to the taxation of aircraft and other instrumentalities of interstate commerce. First, this case marked the end to the notion that the Commerce Clause prohibits the taxation of aircraft and other instrumentalities of interstate commerce. Such instrumentalities can be made to pay their own way. Second, the decision effectively caused the Commerce Clause to assume a dominant role in determining the taxability of the instrumentalities of interstate commerce. In prior decisions, the Due Process Clause had been viewed as setting the minimum requirements which a State had to meet in order to tax the instrumentalities of interstate commerce. However, the decision effectively merged the Due Process requirements into the Commerce Clause requirements.²³³

²²⁸ *Complete Auto Transit*, 430 U.S. at 279 (bracketed numbers added).

²²⁹ See, e.g., *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995); *Assoc. Indus. of Mo. v. Lohman*, 511 U.S. 647 (1994); *D. H. Holmes Co. v. McNamara*, 486 U.S. 24 (1988).

²³⁰ See, e.g., *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

²³¹ See, e.g., *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Comm'r*, 445 U.S. 425 (1980); *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980).

²³² See, e.g., *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), where the court added two additional requirements to be met where foreign commerce is involved. Fractional programs typically do not involve foreign commerce. See also *D. H. Holmes Co. v. McNamara*, 486 U.S. 24 (1988), and *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995) (elaborating on the meaning of the fair apportionment requirement).

²³³ As was pointed out in *Quill Corp. v. Heitkamp*, 504 U.S. 298, 313 (1992), "a corporation may have the 'minimum contacts' with a taxing State as required by

5. *Treatment of Resident and Nonresident Aircraft*

Following *W.R. Grace*, a number of aircraft owners argued that the Commerce Clause prohibited the State from imposing use tax, even where the aircraft was based in the State (a "resident aircraft").²³⁴ The decision in *Complete Auto Transit* effectively eliminated the argument that the Commerce Clause protects a "resident aircraft" from tax. However, the case provided greater protection against taxation of "nonresident aircraft." This is because, in order to tax a nonresident aircraft, the State must be able to show that the aircraft has a "substantial nexus" with the State and that the tax is fairly related to the services provided by the State.

The meaning of the term "substantial nexus" is unclear. In *Miller Bros. Co. v. Maryland*, the Supreme Court held that the occasional use of company trucks to make deliveries into the State was not enough to create nexus.²³⁵ In *Director of Revenue v. Superior Aircraft Leasing Co.*,²³⁶ the Missouri Supreme Court held that use tax could be imposed on a non-resident aircraft which was used 17% of the time in Missouri:

Here, even though the plane was hangared and repairs, if needed, were made in Dayton, Ohio, there were contacts with Missouri sufficient to create a substantial nexus. During the period April 2, 1980, through September 1981, 17.7 percent of the total flight hours were logged on flights to Missouri solely for Superior Aircraft's business. All of these flights, with the exception of one for inspecting a construction site, were recorded as being for board meetings of Superior Aircraft. The time spent in Missouri for each of those trips ranged from several days to approximately a week.²³⁷

Despite the court's conclusion, it is possible that something more than a 17% presence should be required to meet the "substantial nexus" requirement. The continued vitality of the "situs" requirement indicates that an argument can be made that

the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause."

²³⁴ See, e.g., cases cited *supra* note 223. The Due Process Clause does not protect a resident from tax. See, e.g., *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954).

²³⁵ *Miller Bros. Co.*, 347 U.S. 340.

²³⁶ *Dir. of Revenue v. Superior Aircraft Leasing Co.*, 734 S.W.2d 504 (Mo. 1987).

²³⁷ *Id.* at 507. See also *Frank W. Whitcomb Constr. Corp. v. Comm'r of Taxes*, 479 A.2d 164, 165-66 (Vt. 1984) (taxpayer conceded that using the aircraft 17% in the State was enough to justify imposition of a use tax).

“substantial nexus” is the same as “situs.” If so, then a 17% presence would not be enough.

6. *Treatment of Leased Property Temporarily Located in the State*

In *Itel Containers International Corp. v. Huddleston*, the Supreme Court held that the delivery of property to a lessee in the State was a sufficient basis to justify the imposition of State sales tax on all of the lease payments, even though the property was subsequently used entirely outside of the State.²³⁸ However, where the property is not delivered to the lessee in the State, but is merely used in the State, the courts have held that Constitution may bar imposition of the tax.

In *Marx v. Leasing Association, Inc.*, the Mississippi Supreme Court held that a lessor could not be required to pay sales tax where the lessor had not “operated business facilities within the state, domiciled equipment within the state, stationed employees within the state, or entered into leasing agreements within the state.”²³⁹ To the contrary, the court observed that: “The only apparent connections with Mississippi are that each corporation is qualified to do business within the state and their equipment on occasion passes through the state via the highway systems.”²⁴⁰ The court upheld the finding of the lower court that “no sufficient nexus existed to justify the tax sought to be imposed by Mississippi,” observing that:

While it is true that the term “minimal connection” is employed in the test articulated by the Supreme Court, subsequent interpretations have noted that the corporation must “*substantially*” avail itself to the privilege of doing business in the taxing State. Such language certainly would appear to contemplate greater activities than those present in this case.²⁴¹

The court also held that the tax violated the other three parts of the *Complete Auto Transit* test. The court had difficulty determining whether the “fair apportionment” and “non-discrimination” tests had been met because the State had not come up with a clear method of apportioning the lease payments to the State. The court also held that the tax violated the “services provided” test, stating that:

²³⁸ *Itel Containers Int'l Corp. v. Huddleston*, 507 U.S. 60 (1993).

²³⁹ *Marx v. Leasing Assoc., Inc.*, 520 So.2d 1333, 1343 (Miss. 1987).

²⁴⁰ *Id.*

²⁴¹ *Id.* (emphasis in original).

In the present case, unlike *Complete Auto Transit*, the services provided by Mississippi to Ryder and Saunders are minimal. In *Complete Auto Transit*, the taxpayer stored trucks in Mississippi which were then used to pick up and carry shipments of new cars to Mississippi auto dealers. In that case, Mississippi provided substantial services to the taxpayer because it protected its property, its employees, and because *Complete Auto Transit* consistently used the highways of Mississippi to conduct its business. In the present case, neither Ryder nor Saunders have equipment here and do not consistently utilize the Mississippi highways. In fact, they have no control over which highways the lessees of their vehicles use once those vehicles are leased.²⁴²

In *Cally Curtis Co. v. Commissioner*, the Connecticut Supreme Court held that sales tax could not be applied to the rental of video tapes in the State by an out-of-state lessor.²⁴³ Interestingly, the court considered only whether the imposition of the tax violated the Due Process Clause and did not consider the application of the Commerce Clause. This decision indicates that the activity would not have met either the “substantial nexus” or the “services provided” requirement of *Complete Auto Transit*.

In short, just because Curtis leased instead of sold the films in Connecticut, does not mean that Curtis “receiv[ed] benefits from [Connecticut] for which [Connecticut] has the power to exact a price.’ Although Curtis did have property (films) within Connecticut, such contact with Connecticut, like the contact of the appellant’s delivery trucks with Maryland in *Miller Brothers Co. v. Maryland*, *supra*, was *de minimus*, as the films were only in the State for three-day periods, and did not benefit from the services of local government.²⁴⁴

²⁴² *Id.* at 1345.

²⁴³ *Cally Curtis Co. v. Comm’r*, 572 A.2d 302 (Conn. 1990).

²⁴⁴ *Id.* at 306 (citations omitted).

V. STATE SALES AND USE TAX

A. THE GENERAL RULES

1. *The Sales and Use Tax*

The States first enacted sales and use taxes during the Depression of the 1930s as a means of raising revenues.²⁴⁵ Today, almost every State imposes some kind of sales and use tax.²⁴⁶

The sales tax is a one-time tax imposed on the sale at retail of tangible personal property within the State. The tax is a percentage of the sales price, and ranges from less than 2% to over 8%.²⁴⁷ The tax may be characterized as an excise tax on the sale or as a privilege tax on the seller.²⁴⁸ There are a number of exclusions and exemptions from tax.²⁴⁹ One of the most important exclusions is the "resale exclusion," which is intended to insure that the tax is imposed only on the final sale at retail. In contrast with an exemption, an exclusion is broadly construed in favor of the taxpayer.²⁵⁰ Many States have exclusions and exemptions which apply to aircraft, but these vary widely from State to State.

Because sales tax can easily be avoided by taking delivery of the property outside of the State, most States with a sales tax have also adopted a use tax to serve as a backstop.²⁵¹ The use

²⁴⁵ *Lockwood v. Nims*, 98 N.W.2d 753, 754 (Mich. 1959) ("The sales tax came to us in the depth of a great depression in order to provide the means for fulfilling desperate governmental needs.").

²⁴⁶ The only States which do not presently have some kind of sales tax are Montana, New Hampshire, and Oregon.

²⁴⁷ The Delaware tax on retailers is .75%. DEL. CODE ANN. tit. 30, § 2905(b) (1) (2001). Some local jurisdictions in California, New York and Texas have rates in excess of 8%. See, e.g., CAL. REV. & TAX CODE § 6901 (West 2002).

²⁴⁸ See, e.g., CAL. REV. & TAX. CODE § 6051 (West 2002) ("For the privilege of selling tangible personal property at retail . . ."); DEL. CODE ANN. tit. 30, § 2905 (2001) ("retailer license requirements"); and N.M. STAT. ANN. § 7-9-2 (Michie 2002).

²⁴⁹ See, e.g., *Finch, Pruyn & Co. v. Tully*, 419 N.Y.S.2d 232 (N.Y. App. Div. 1979) ("[a]lthough exemptions from taxation must be construed against the taxpayer, the reverse is true when the inquiry is directed at whether the property is subject to any tax whatever").

²⁵⁰ See, e.g., *Southwestern Bell Tel. Co. v. State Comm'n of Revenue & Taxation*, 212 P.2d 363, 367 (Kan. 1949) ("There is one basic principle about our sales tax act. It is that the ultimate consumer should pay the tax and no article should have to carry more than one sales tax.").

²⁵¹ See, e.g., *Morrison-Knudsen Co. v. State Tax Comm'n*, 44 N.W.2d 449, 452 (Iowa 1950) ("[t]he principal purpose of the use-tax law was to remedy the evil of out-of-state buying to escape the sales tax"); *UPS v. Arnold*, 542 P.2d 694, 697 (Kan. 1975) ("A problem arose, however, with the realization that property could

tax is generally imposed on the privilege of using property in the State. The use tax generally has the same exclusions, exemptions, and tax rates as the sales tax. The Supreme Court has held that a State cannot impose a use tax which discriminates against an out-of-state purchaser.²⁵² In order to avoid double-taxation, the States generally allow a credit for taxes paid to other States.²⁵³ The Supreme Court has indicated that, in the absence of apportionment, such a credit is required.²⁵⁴

The taxation of leases has evolved. Many States originally took the position that the lessor was the consumer of the property and that sales or use tax should be imposed when the property was sold to or used by the lessor.²⁵⁵ While a few States still take this position, most States now consider the lease to be the

be purchased outside the state and subsequently brought into the state, thereby avoiding the general sales tax. To rectify this situation, numerous state legislatures enacted compensating tax laws to impose a tax on the sales of property purchased beyond their borders which otherwise would be subject to the sales tax.”).

²⁵² *Assoc. Indus. of Mo. v. Lohman*, 511 U.S. 641 (1994) (State cannot impose a higher use tax rate on property purchased from out-of-state vendor); *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963) (isolated sale exemption and taxable basis of self-constructed property).

²⁵³ *See, e.g., CALIF. REV. & TAX. CODE* § 6406 (West 2002); *N.Y. TAX LAW* § 1118(7) (Consol. 2002).

²⁵⁴ *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 192 n.6 (1995) (citations omitted):

Although we have not held that a State imposing an apportioned gross receipts tax that grants a credit for sales taxes paid in-state must also extend such a credit to sales taxes paid out-of-state, we have noted that equality of treatment of interstate and intrastate activity has been the common theme among the paired (or “compensating”) tax schemes that have passed constitutional muster. We have indeed never upheld a tax in the face of a substantiated charge that it provided credits for the taxpayer’s payment of in-state taxes but failed to extend such credit to payment of equivalent out-of-state taxes. To the contrary, in upholding tax schemes providing credits for taxes paid in-state and occasioned by the same transaction, we have often pointed to the concomitant credit provisions for taxes paid out-of-state as supporting our conclusion that a particular tax passed muster because it treated out-of-state and in-state taxpayers alike. A general requirement of equal treatment is thus amply clear from our precedent. We express no opinion on the need for equal treatment when a credit is allowed for payment of in-or out-of-state taxes by a third party.

²⁵⁵ *See, e.g., Union Oil Co. v. State Bd. of Equalization*, 386 P.2d 496 (Cal. 1963); *Philco Corp. v. Dep’t of Revenue*, 239 N.E.2d 805 (Ill. 1968); *Cedar Valley Leasing, Inc. v. Iowa Dep’t of Rev.*, 274 N.W.2d 357 (Iowa 1979); *Commercial Leasing, Inc. v. Johnson*, 197 A. 2d 323 (Me. 1964). *See also IBM v. State Tax Comm’n*, 362 S.W.2d 635 (Mo. 1962) (rentals not taxable as sales).

sale at retail and impose tax on the lease payments.²⁵⁶ Where the lessor purchases the property exclusively for lease, the sale to the lessor will generally be considered a nontaxable sale for resale.²⁵⁷

As a general rule, sales tax is not imposed on transportation services.²⁵⁸ The transportation provider is considered the consumer of any tangible property used to provide those services. In the absence of a special exemption (such as the "common carrier" exemption), sales or use tax will be imposed when the property is sold to or used by the provider.²⁵⁹

a. Lease vs. Transportation Service

Because of the difference in the taxation of leases and transportation services, the distinction between a lease and a transportation service is important. In defining a lease, the States generally use the same common law test which is used for other tax purposes.²⁶⁰ For example, the rental of property without an operator is generally considered a lease while the rental of property with an operator will generally be a service, particularly

²⁵⁶ The two most notable "holdouts" are Illinois and Maine. *See, e.g.*, ILL. ADMIN. CODE tit. 86, § 130.220(a) (2002) ("Effective August 1, 1967, the sale of tangible personal property to a purchaser who will act as a lessor of such tangible personal property is a sale at retail and is subject to Retailers' Occupation Tax."); *James A. Dowling v. State Tax Assessor*, 478 A.2d 1123 (Me. 1984) (Resale exemption not applicable where property purchased for lease.). California still treats the lessor of "mobile transportation equipment" (including aircraft) as the user, but allows the lessor to elect to pay tax on the lease payments. *See* CAL. CODE REGS. tit. 18, § 1661 (2002).

²⁵⁷ *See, e.g.*, FLA. ADMIN. CODE ANN. r. 12A-1.007(14)(b)(1) (2002) ("The purchase of an aircraft, boat, mobile home, or motor vehicle exclusively for rental purposes may be made tax exempt when the purchaser/lessor issues a resale certificate to the dealer at the time of purchase in lieu of paying tax. The lessor shall collect tax from his customers on the total rental charge."); 34 TEX. ADMIN. CODE § 3.294(j)(1) (Vernon 2000) ("The purchaser of property which is to be held for lease within the United States of America, its territories and possessions, or within the United Mexican States may issue a resale certificate in lieu of the sales tax or use tax at the time of purchase.")

²⁵⁸ *See, e.g.*, FLA. ADMIN. CODE r. 12A-1.071(10) (2002).

²⁵⁹ *See, e.g.*, WASH. ADMIN. CODE § 458-20-178 (2002) ("[a] lessor who leases equipment with an operator is deemed a user and is liable for the tax on the full value of the equipment.")

²⁶⁰ *See, e.g.*, *Duncan Crane Serv., Inc. v. Dep't of Revenue*, 723 P.2d 480 (Wash. Ct. App. 1986) holding that a regulation which ignored the common law test was invalid ("the drafters of the regulation were unconcerned with whether the parties to the rental agreement had arranged what the common law recognizes as a lease").

where the operator remains under the control of the lessor.²⁶¹ Where the lessee obtains the property and operators from different unrelated sources, the rental of the property would presumably be considered a lease. This appears to be the same kind of test that is used by the FAA to distinguish between a "wet lease" and a "dry lease."

b. Tax Ownership of the Property

Determining the tax owner of property is also important for sales and use tax purposes. A change in tax ownership is necessary to trigger application of the sales tax, and only the tax owner is subject to use tax and entitled to claim certain exemptions.

In general, the sales tax laws provide that a sale includes a transfer of "title and possession."²⁶² However, where the transaction is ambiguous, the States tend to consider the same factors that are considered for income tax purposes, such as who has the burdens and benefits of ownership. These factors have been used to determine the location of the sale, whether a lease is an operating lease or a financing lease, and whether a sale-lease-back transaction is really a loan.²⁶³ In most cases, the same per-

²⁶¹ See, e.g., FLA. ADMIN. CODE ANN. r. 12A-1.071(d) (2002) ("When the owner of equipment furnishes the operator and all operating supplies, and contracts for their use to perform certain work under his direction and according to his customer's specifications, and the customer does not take possession or have any direction or control over the physical operation, the contract constitutes a service transaction and not the rental of tangible personal property and no tax is due on the transaction."); N.Y. COMP. CODES R. & REGS. tit. 20 § 541.2(p)(2) (2002) ("when a rental, lease or license to use a vehicle or equipment includes the services of a driver or operator, such transaction is presumptively the sale of a service, rather than the rental of tangible personal property, where dominion and control over the vehicle or equipment remain with the owner or lessor of the vehicle or equipment.").

²⁶² See, e.g., CAL. REV. & TAX. CODE § 6006 (West 2002) ("Sale' means and includes: (a) Any transfer of title or possession . . . of tangible personal property for a consideration."); FLA. STAT. ANN. § 212(15) (West 2001) ("Sale" means and includes: (a) Any transfer of title or possession, or both . . . of tangible personal property for a consideration."); N.Y. TAX LAW § 1101(b)(5) (McKinney 2000) (Sale, selling or purchase. Any transfer of title or possession or both . . . for a consideration"); TEX. TAX CODE ANN. § 151.005 (Vernon 2002) ("Sale' or 'purchase' means any of the following when done or performed for consideration: (1) a transfer of title or possession of tangible personal property . . .").

²⁶³ See, e.g., FLA. ADMIN. CODE ANN. r. 12A-1.071(1)(d) (2002) ("Where a contract designated as a lease transfers substantially all the benefits, including depreciation, and risks inherent in the ownership of tangible personal property to the lessee, and ownership of the property transfers to the lessee at the end of the lease term, or the contract contains a purchase option for a nominal amount, the

son is the tax owner for both the income tax and the sales and use tax.²⁶⁴

2. *Taxation of Purchase and Use of Own Aircraft*

The sales tax on aircraft is easily avoided because the sales tax applies only if the aircraft is delivered to the purchaser in the State. This means that the purchaser has the option of choosing the State in which the sale takes place. The purchaser can take delivery in a State which does not have a sales tax or which exempts or limits the sales tax on aircraft.²⁶⁵ Alternatively, the purchaser can take delivery in a State which has a "fly away" exemption, which generally allows a nonresident to avoid paying sales tax where the aircraft is immediately removed from the State.²⁶⁶

The use tax is more difficult to avoid. If the aircraft is based and primarily used outside of the State by a nonresident, the Constitutional limitations discussed above may prevent imposition of the use tax. In addition, many States have specific rules which limit the tax on non-resident aircraft. Some States exempt aircraft which are based and primarily used outside of the State.²⁶⁷ Some States do not tax aircraft which are not used in the State for the requisite number of days.²⁶⁸ Finally, under the rationale that the use tax was intended only to backstop the sales tax, many States impose use tax only on property "purchased for use" in the State.²⁶⁹

Where the aircraft is based or primarily used in the State or where the owner is a resident, the use tax will generally apply. The only way to avoid imposition of the tax is to find a state-

contract shall be regarded as a sale of tangible personal property under a security agreement (commonly referred to as a capital lease, sales-type lease, or direct financing lease) from its inception.").

²⁶⁴ See, e.g., *Northrop Corporation v. State Board of Equalization*, 110 CA3d 132 (Calif. Ct. App., Sept. 10, 1980) (The court followed the IRS income tax characterization of a transaction for sales tax purposes.).

²⁶⁵ See, e.g., CONN. GEN. STAT. § 12-412(99) (2001) (exemption for aircraft having a maximum certificated takeoff weight of 6,000 lbs. or more); N.C. GEN. STAT. § 105-164.4(a)(1b) (2002) (maximum tax on aircraft is \$1,500); S.C. CODE ANN. § 12-36-2110(A)(1) (2001) (maximum tax on aircraft is \$300).

²⁶⁶ See, e.g., CAL. REV. & TAX. CODE § 6366(a)(1) (West 2002); FLA. STAT. ANN. § 212.05(2) (West 2001); TEX. TAX CODE ANN. § 151.328(a)(4) (Vernon 2002).

²⁶⁷ See, e.g., 34 TEX. ADMIN. CODE § 3.297(c)(3) (West 2002).

²⁶⁸ See, e.g., KAN. STAT. ANN. § 79-3704(a) (2001); VA. CODE ANN. §§ 5.1-5, 58.1-1502 (Michie 2002).

²⁶⁹ See, e.g., CAL. REV. & TAX. CODE § 6201 (West 2002); FLA. STAT. ANN. § 212.05 (West 2001); TEX. TAX CODE ANN. § 151.101 (Vernon 2002).

defined exclusion or exemption from tax. This can prove difficult. For example, although most States have a "commercial use" exemption, there are only a few States where this exemption applies to aircraft operated under Part 91.²⁷⁰

The use of a management company should not change this result, particularly where the owner retains operational control of the aircraft. For example, in *New York Times Co. v. Comm'r*, the Board considered the taxability of an arrangement where an aircraft was leased by the New York Times ("Times") from a wholly owned subsidiary.²⁷¹ The Times contracted with AFM, an unrelated company, to provide pilot and management services. AFM also instituted an interchange program in which the Times participated. Although the Times argued that the aircraft had effectively been sold to AFM, the Board held otherwise. The Board noted that "the distinction between a [taxable] lease or rental and a service that requires use of property by the service provider can be difficult to draw."²⁷² However, the Board was aware that the arrangement was designed to allow the aircraft to be operated under Part 91, observing that the Times "retained as much control over the aircraft as was compatible with the FAA regulatory regime."²⁷³ The Board concluded that AFM was "a transportation service provider operating and maintaining aircraft Appellant controlled" and that "the interchange agreement did not confer greater control of the aircraft on A.F.M."²⁷⁴ These conclusions were apparently not contested when the case was appealed to the Massachusetts Supreme Judicial Court, which affirmed the decision of the Board that the aircraft was subject to use tax.²⁷⁵

3. Taxation of Joint Ownership Arrangements

The sale or use of an undivided interest in an aircraft appears to be taxable in the same way as the sale or use of a whole air-

²⁷⁰ See, e.g., MD. CODE ANN., TAX-GEN. § 11-208(c)(1) (2001) (exempts aircraft "used principally to cross State lines in interstate or foreign commerce"); Pasquale & Bowers, Op. N.Y. Comm'r Tax & Fin. TSB-A-96(49)S (1996).

²⁷¹ *New York Times Co. v. Comm'r*, Mass. App. Tax Bd., Dkt. No. F214442 (July 8, 1997), *aff'd* 693 N.E.2d 682 (Mass. 1998).

²⁷² *Id.* (quoting JOSEPH X. DONOVAN, THE MASSACHUSETTS SALES AND USE TAX MANUAL REVISED 169-70 (1995)).

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ *New York Times Co. v. Comm'r*, 693 N.E.2d 682 (Mass. 1998).

craft.²⁷⁶ However, where the owners are residents of different States, the taxation of the different interests could vary. For example, if an interest owner is a resident of the State where the aircraft is used, the owner may not be able to take advantage of an exemption for aircraft owned by a nonresident which are based and primarily used outside of the State.

4. *Taxation of Dry Lease Exchange*

The dry lease exchange should have a significant impact on the sales and use tax consequences to the participants. This is because, in most States, property which is purchased and used exclusively for lease to others is exempt from sales and use tax under the resale exclusion.

The fact that the lease takes the form of a barter should not change this result. Most, if not all, State sales tax laws provide that barter transactions are subject to tax.²⁷⁷ This is consistent with the State sales and use tax objective of insuring that the sales or use tax is imposed on the final consumer.²⁷⁸

The fact that the interest owner may use his own aircraft should not violate the requirement that the property be purchased and used "exclusively for lease" since any access to the aircraft is pursuant to the fractional agreements and not pursuant to a retained right.²⁷⁹

In recent years, many States have added a requirement that, in order to take advantage of the resale exclusion, the lessor

²⁷⁶ See, e.g., ILL. GEN. INFO. LETTER ST 94-0392 (1994) (dealer selling half interest in aircraft to another dealer).

²⁷⁷ See, e.g., CAL. CODE REGS. tit. 18, § 1654 (2002). Barter, Exchange, Trade-Ins and Foreign Currency Transactions, FLA. STAT. ANN. § 212(15) (West 2001) ("Sale" means and includes: (a) Any transfer of title or possession, or both, exchange, barter, license, lease, or rental, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration."); N.Y. TAX LAW § 1101(b)(5) (McKinney 2000) (Sale, selling or purchase. Any transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume . . . for a consideration"); TEX. TAX CODE ANN. § 151.005 (Vernon 2002) ("Sale" or "purchase" means any of the following when done or performed for consideration: . . . (2) the exchange, barter, lease, or rental of tangible personal property;").

²⁷⁸ As can be seen, the treatment of barter exchanges can vary depending on the type of tax involved. Excise taxes, such as the transportation tax and the sales tax, tend to tax particular types of transactions, including barter exchanges, whereas an income tax will apply only if there is a net "accretion to wealth."

²⁷⁹ Although the interest owner can request to fly in his own aircraft, the program manager generally has the unfettered right to substitute another aircraft.

must be registered to collect tax in the State.²⁸⁰ However, a review of these requirements generally reveals that they were intended only to prevent in-State purchasers from unlawfully evading the sales tax.²⁸¹ They were not intended to prevent out-of-State purchasers from lawfully claiming exemption from use tax where the property is later brought into the State. If these requirements also applied for use tax purposes, then, in operation, they would result in unlawful discrimination against out-of-State purchasers.²⁸²

As a general rule, the lease payments are subject to tax only in the State where the aircraft is based. For example, in *Huntington Leasing Co. v. Lindley*, the Ohio Board of Tax Appeals, held that sales tax was not applicable to lease payments for an aircraft which merely entered Ohio from time to time, when necessary during the usual course of the lessee's business.²⁸³ The only connection that the aircraft had to Ohio was that the lease agreement was executed in Ohio and the aircraft was registered in Ohio. Possession of the aircraft was transferred outside of Ohio and the aircraft was continuously based outside of Ohio.²⁸⁴

Even in the States where tax is imposed on the lessor, there may be limitations which prevent the imposition of tax on aircraft which are based outside of the State. For example, in *Realco Services, Inc. v. Halperin*, the Supreme Judicial Court of Maine held that the use tax did not apply to the rental of piggy-back trailers in the State.²⁸⁵ Realco Services operated the Na-

²⁸⁰ See, e.g., FLA. ADMIN. CODE ANN. r. 12A-1.071(2)(a)(1) (2002) ("Tangible personal property purchased exclusively for leasing purposes may be purchased tax exempt, *providing the lessor is registered with the Department as a dealer at the time of purchase and issues the vendor a valid resale certificate in lieu of tax. Any purchases made prior to the time of registration as a dealer are subject to tax.*" (emphasis added)).

²⁸¹ These unscrupulous purchasers could be: (1) nonresidents who depart the taxing jurisdiction; or (2) residents who hope that they won't get caught in a use tax audit.

²⁸² See, e.g., *Assoc. Indus. of Mo. v. Lohman*, 511 U.S. 641 (1994); *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963).

²⁸³ *Huntington Leasing Co. v. Lindley*, Ohio BTA, Case No. 82-A-1407 (Feb. 19, 1986).

²⁸⁴ There are, of course, exceptions to this rule. Some States where aircraft are based allow an exclusion for out of State use. See, e.g., N.M. ADMIN. CODE. tit. 3, § 3.2.1.17(D), "Multistate Use of Leased Equipment." Conversely, some States will attempt to tax all of the lease payments on aircraft delivered to the lessee in the State, regardless of where the aircraft is based. See, e.g., *Itel Containers Int'l Corp. v. Huddleston*, 507 U.S. 60 (1993) where Tennessee successfully took this position.

²⁸⁵ *Realco Services, Inc. v. Halperin*, 355 A.2d 743 (1976).

tional Railroad Trailer Pool (Pool), with which most of the major railroads in the United States and Canada are affiliated by contract. Realco purchased "piggyback trailers" and placed them in circulation for the benefit of all members of the Pool. In prior cases, the court had held that "mere receipt of rentals was not a sufficient exercise of right or power over tangible personal property to subject a non-resident lessor to the obligation to pay a use tax thereon."²⁸⁶ In response, the Maine Legislature broadened the definition of use to include the "derivation of income by a lessor in the form of rental provided, however, that the 'tangible personal property' [was] located in this state. ."²⁸⁷ The court in Realco Services reviewed this history and concluded that "it seems self-evident that the Legislature intended the words "located in this State" to relate to personal property which, in fact, had come to rest within the State with a corresponding loss of all transient characteristics."²⁸⁸ Since the piggyback trailers did not meet this requirement, the court held that Realco was not subject to use tax on the trailers.

B. CHARACTERIZATION OF FRACTIONAL PROGRAMS

To date, the only States to address the sales tax characterization of fractional programs are New York and Texas.

1. *The New York Ruling*

In *The Gap, Inc.*, the New York Commissioner of Taxation and Finance ruled that a fractional program is a non-taxable transportation service.²⁸⁹ The ruling was requested by the fractional customer ("Petitioner"). The basis for this conclusion is unclear. Although the facts in the ruling indicate that the selling company (referred to as "Seller") and the management company (referred to as "Manager") were separate legal entities, the Commissioner appeared to ignore these separate legal entities.

²⁸⁶ *Id.* at 746. See generally *Automatic Canteen Co. v. Johnson*, 190 A.2d 734 (Me. 1963) (use tax on non-resident lessor upheld where lessor inspected, maintained and repaired the property in the State); *South Shoe Mach. Co. v. Johnson*, 188 A.2d 353 (Me. 1963) (no use tax on property from non-resident lessor who had no other connection with the State); *Trimount Coin Mach. Co. v. Johnson*, 124 A.2d 753 (Me. 1956) (no tax on leased exclusively for use Maine from non-resident lessor).

²⁸⁷ *Id.* at 746.

²⁸⁸ *Id.* at 747.

²⁸⁹ *The Gap, Inc.*, TSB-A-00(3)S, Adv. Op. N.Y. Comm'r Tax. & Fin. (Jan. 28, 2000).

The Commission began by concluding that, because of the nature of the fractional agreements, the aircraft was never really sold to the interest owner:

The documents furnished by Petitioner provide that the interest in the aircraft conveyed by Seller to each owner is subject to the rights of each of the other additional interest owners. All of the owners of an interest in the aircraft have entered into the Master interchange agreement with Manager, whereby another aircraft may be substituted by Manager if the aircraft in which Petitioner purchases an interest is not available. When the aircraft is not in use by one of the owners, Manager retains the right to use it. These arrangements among each of the owners and between each owner and Manager significantly limits the control any single owner may exercise over the aircraft. *Therefore, the interest that will be conveyed to Petitioner by the "bill of sale" is not the transfer of possession of tangible personal property and the word "owner" as used in the context of the agreements does not denote ownership in the typical sense which involves the holding of title to property.*²⁹⁰

The Commissioner then indicated that the question was whether the transaction constituted a lease or a service, citing N.Y. St. Reg. 526.7(e), relating to a "rental, lease or license to use," and from Technical Services Bureau Memorandum entitled *Bus Company Transactions - Transportation Service vs. Equipment Rental*.²⁹¹

Whether Petitioner's purchase constitutes a *taxable rental* of tangible personal property rather than the purchase of an exempt transportation service turns upon the question of dominion and control. While the provisions of TSB-M-84(7), *supra*, do not specifically apply to the chartering of an aircraft, the criteria set forth therein are useful in determining whether Petitioner has obtained dominion and control of the aircraft *within the meaning of Section 526.7(e) of the Sales and Use Tax Regulations*.²⁹²

While the Commissioner did not identify the lessor of the aircraft, the Commissioner appeared to focus solely on the role of the management company in making this determination:

In Petitioner's case, the management agreement provides that Manager will furnish qualified pilots to operate the aircraft. The

²⁹⁰ *Id.* (emphasis added).

²⁹¹ *Bus Co. Transactions - Transp. Serv. vs. Equipment Rental*, TSB-M-84(7)S, Adv. Op. N.Y. Comm'r Tax. & Fin. (Apr. 10, 1984). This kind of analysis would have made more sense if the selling company and the management company were the same legal entity. However, the facts indicate that they were not.

²⁹² *Id.* (emphasis added) (citations omitted).

pilots are paid by Manager, who also provides, at its own expense, recurrent pilot training, pilot medical examinations and uniforms. In some instances a pilot may be chosen by Petitioner but only subject to the approval of Manager. While Petitioner will select the date, time, point of departure and destination with regard to a particular flight, Manager makes all necessary take-off, flight and landing arrangements, and the pilots use their own discretion in performing the flight services and select their own routes. Manager has the overall responsibility to manage and operate the aircraft and pays all operating expenses such as fuel, hangar and general storage fees, flight planning and weather services and aircraft hull insurance (which names Manager and all owners as insureds and provides for any insurance proceeds to be paid to Manager for repair or replacement of the aircraft).²⁹³

Having made these observations, the Commissioner appeared to conclude that the interest owner had relinquished control to the management company:

In its purchase of an interest in the aircraft for the purpose of transportation of its officials, employees and guests, Petitioner has fulfilled none of the requirements listed in TSB-M-84(7)S, *supra*, necessary to *retain* dominion and control over the aircraft.²⁹⁴

But, in the very next sentence, the Commissioner appears to return to the original premise, concluding that there never was a sale of the aircraft to the interest owner:

Some additional factors set forth in the agreements which support the view that sufficient custody over the aircraft along with the right to exercise the necessary direction and control *have not been transferred to Petitioner for there to be a retail sale of such aircraft* are:

1. Manager arranges for the aircraft to be inspected, maintained, serviced, repaired, overhauled and tested in accordance with approved Federal Aviation Administration standards and guidelines.
2. Manager maintains all records, logs and other materials required by the FAA to be maintained in respect to the aircraft.
3. Manager retains the right to use the aircraft during periods it is not being utilized in the transportation of Petitioner or other owners and to retain any money it earns in this use of the aircraft.

²⁹³ *Id.*

²⁹⁴ *Id.* (emphasis added).

4. Seller's obligations to sell the interest to Petitioner are subject to Petitioner becoming a party to the Management, Joint Ownership and Master interchange agreements.
5. Seller has the right of first refusal to purchase Owner's interest in Aircraft and may, after five years, compel Owner to sell its interest to Seller at a repurchase price based on the then fair market value of Aircraft.²⁹⁵

Finally, the Commissioner apparently tried to cover all the bases by saying that there was neither a sale nor a rental to the interest owner:

Therefore, possession, command and control of the aircraft have not been transferred to Petitioner, and what is being furnished to Petitioner is a nontaxable transportation service and not a taxable *purchase or rental* of tangible personal property pursuant to Sections 1101(b)(5) and 1105(a) of the Tax Law.²⁹⁶

As can be seen, the Commissioner also took this opportunity to substitute the federal transportation tax "possession command and control" test for the New York "dominion and control" test and to cite a couple of federal transportation tax rulings, which raises even further questions about the meaning of this ruling.²⁹⁷

Although both Part 91 and "operational control" play a key role in fractional programs, the Commissioner did not make any reference to either. Nor did the Commissioner appear to give any weight to the fact that the aircraft and the crews were obtained from unrelated legal entities, i.e., the fractional owners and the management company, respectively. All of the rulings cited, including the IRS rulings, dealt with transactions where the property and services were provided by the same legal entity.²⁹⁸

²⁹⁵ *Id.* (emphasis added).

²⁹⁶ *Id.* (emphasis added) (citations omitted).

²⁹⁷ In Rev. Rul. 76-394, 1976-2 C.B. 355, the transportation tax applied where a company provided transportation to related companies which were not members of the same affiliated group. In Rev. Rul. 68-343, 1968-1 C.B. 491, the transportation tax applied where a company provided transportation to participating and related companies. In both rulings, the same company providing the transportation owned the aircraft and employed the pilots, albeit with the concurrence of the participants.

²⁹⁸ In *Bus Company Transactions*, *supra* note 289, the bus and drivers were provided by the same company. In *Klondike Cruises, Inc.*, TSB-A-98(46)S, Adv. Op. N.Y. Comm'r Tax. & Fin. (July 29, 1998), and *Henry F. Geerken*, TSB-A-97(52)S, Adv. Op. N.Y. Comm'r Tax. & Fin. (Aug. 25, 1997), the ship and crew were provided by the same company. In *Limousine Operators of Western New York, Inc.*, TSB-

While the rationale for the ruling may be elusive, the result was favorable to the interest owner. Consequently, it is unlikely that any other interest owner will ask the Commissioner to reconsider, even if they may disagree with the characterization of the transaction.

Nor is it likely that the ruling will be called into question by the fractional companies. This is because, under New York law, an aircraft which is used primarily to provide transportation is exempt from sales or use tax, even where the transportation is provided under Part 91.²⁹⁹

2. *The Texas Pronouncement*

In the December 2000 issue of "Tax Policy News," the Texas Comptroller issued a "FYI: Sales Tax," explaining the proper treatment of fractional interests for Texas sales and use tax purposes.³⁰⁰ The Comptroller discussed the operation of a fractional program and the four major agreements, starting with "a purchase agreement between a sponsor and an interest owner."³⁰¹ The Comptroller stated that, "The four agreements must be construed together, in order to determine the parties' intent."³⁰² The Comptroller observed that:

While the Federal Aviation Administration has treated fractional ownership as non-commercial transportation, the Internal Revenue Service has ruled that for excise tax purposes fractional-ownership plans are more in the nature of a commercial transportation service than a co-tenancy because owners have surrendered possession, command, and control of the aircraft.³⁰³

Finally, the Comptroller concluded that, for sales and use tax purposes:

Although the participant provides some direction to the pilots, possession of the aircraft remains with the seller. In this situation, the participant is contracting for a nontaxable air charter

A-88(55)S, Adv. Op. N.Y. Comm'r Tax. & Fin. (Oct. 27, 1988), the limousines and drivers were provided by the same company. In IRS Rev. Ruls. 76-394 and 68-343, the plane and pilots were provided by the same company.

²⁹⁹ See, e.g., Pasquale and Bowers, TSB-A-96(49)S, Adv. Op. N.Y. Comm'r Tax. & Fin. (Aug. 1, 1996); Citiflight, Inc., TSB-A-00(30)S, Adv. Op. N.Y. Comm'r Tax. & Fin. (Sept. 11, 2000).

³⁰⁰ Texas State Comptroller, Tax Policy News, Vol. X, issue 8 (Dec. 2000), available at <http://www.cpa.state.tx.us/taxinfo/taxpnw/tpn2000/tpn01201.html>.

³⁰¹ *Id.*

³⁰² *Id.*

³⁰³ *Id.*

service, and a taxable sale or rental of an aircraft to the participant does not occur. This is true regardless of whether the charges for pilot or other labor are separately stated from the charges for the aircraft. The sponsor is responsible for any tax on the purchase of the airplane.³⁰⁴

This FYI indicates that, as far as the Texas Comptroller is concerned, the aircraft is never sold to the interest owner and the selling company is responsible for the taxes on the aircraft. Unlike the New York ruling, it is not clear whether the program described in the FYI involved a separate selling company and management company. As in the case of the New York ruling, the Comptroller appeared to place greater weight on the IRS treatment of these programs than on the FAA treatment.

3. Critique

Both the New York Ruling and the Texas Pronouncement suggest that there is a tendency among the State tax authorities to conclude that the interest owner is not the owner of the aircraft, despite the language of the agreements and despite the interest owner's assumption of the benefits and burdens of ownership, including risk of loss. To the extent that this conclusion is based on the finding of the court in *Executive Jet Aviation*, the reliance is misplaced. As already discussed in connection with the income tax, there is nothing in that decision to indicate that the interest owner should not be considered the owner of the aircraft, for tax or any other purpose.

The proper characterization for sales tax purposes appears to be that the fractional interest owner is the purchaser of an asset which is held exclusively for resale. This means that, in most States, the purchase of the interest would be exempt and tax would be imposed on the lease payments.

The decision of the court in *New York Times v. Comm'r* provides a helpful analogy.³⁰⁵ In that case, the Board held that the lease of an aircraft from a related company and the use of an unrelated company to provide management and pilot services were two separate transactions - despite the taxpayer argument that the two transactions should be combined. As a result, tax was imposed on the lease payments.

³⁰⁴ *Id.*

³⁰⁵ *New York Times v. Comm'r*, Docket No. F214442 (Mass. App. Tax Bd. July 8, 1997), *aff'd* 693 N.E.2d 682 (Mass. 1998).

C. CONSEQUENCES AND REMAINING ISSUES

1. *Tax on the Purchase and Use of the Fractional Interest*

The risk that sales tax will be imposed on the purchase of the aircraft interest is generally eliminated by the practice of insuring that the aircraft is delivered in a State which does not tax the sale of aircraft. The risk that use tax will be imposed on the aircraft interest is significantly reduced by a combination of the resale exclusion and the Constitutional and State limitations on taxation of nonresident aircraft.

The Constitutional and State limitations will not protect a small fractional program which operates out of a single State. Nevertheless, in most States, the resale exclusion should be available to protect the aircraft interest from imposition of the sales or use tax.

2. *Tax on the Lease Payments*

Ordinarily, where the resale exclusion applies, then sales tax is imposed on the lease payments. In the case of a small fractional program which operates out of a single State, sales tax can be collected and paid to that State. However, in the case of a multistate fractional program, there are several questions which must be resolved:

First, what is the level of activity required to subject the lease payment to tax? If Constitutional or State limitations would prevent tax from being imposed on the whole aircraft, then, presumably, tax should not be imposed on the lease payments. Some courts have expressed the sentiment that a nonresident lessor is entitled to even greater protection.³⁰⁶ On the other hand, some States appear to have taken the position that delivery of the property to the lessee is enough to trigger liability for sales tax on the lease payments.³⁰⁷ Although the Supreme Court appears to have approved of the use of this method,³⁰⁸ there

³⁰⁶ Marx v. Leasing Assoc., Inc., 520 So.2d 1333 (1987).

³⁰⁷ See, e.g., *Itel Containers Int'l Corp. v. Huddleston*, 507 U.S. 60 (1993). However, because each flight is a separate "lease," the tax exposure is limited to the tax on that flight.

³⁰⁸ *Id.* For some reason, *Itel* did not appeal the decision of the lower court that this approach was permitted under *Complete Auto Transit*. Nevertheless, the courts could have upheld imposition of the tax under the theory that the delivery to the lessee was like a sale.

may be State limitations on taxation of nonresident aircraft which prevent imposition of the sales tax.³⁰⁹

Second, what is the tax basis? Unlike the federal transportation tax, which is imposed on the entire hourly cost, the sales and use tax should only be imposed on the amount paid for the aircraft and fuel and should not be imposed on the amount paid for the pilots.

3. *No Safe Harbors?*

A cautious interest owner might be tempted to try to avoid problems by paying tax in some State. For example, the owner might decide to pay use tax to their home State based on the purchase price of their interest. However, this may not be a good idea. First, paying tax to one State does not prevent other States from asserting their right to tax the aircraft. Although the States are generally required to give credit for taxes paid to other States, credit is not allowed where the tax was improperly paid.³¹⁰ If the aircraft never enters the home State, then there is no legal basis for paying the use tax. By the time the matter is resolved, the statute of limitations for obtaining a refund of tax from the wrong State may have passed. Second, even if the tax was properly paid, the other States may not allow credit for all taxes paid. For example, a State taxing the lease payments may not allow a credit for tax paid on the use of the aircraft, since the use and lease of the aircraft are two separate transactions.³¹¹

³⁰⁹ For example, if the delivery to the lessee is like a sale and the State has a "fly-away" exemption, tax might not apply.

³¹⁰ Article V of the Multistate Tax Compact, which has been adopted by most States, requires that a credit be allowed only for "legally imposed sales or use taxes." See, e.g., MINN. R. 8130.4400, subpart 2 (2001) ("A Minnesota taxpayer who erroneously pays a sales tax to another state may not take a credit against the tax due Minnesota on the Minnesota return. Credit is allowed against the tax due Minnesota if the Minnesota taxpayer has legally paid a sales tax to another state and may only be taken by the person who paid the tax to the other state."); N.Y. TAX LAW § 1118(7) (McKinney 2002) (credit allowed "to the extent that a retail sales or use tax was legally due and paid thereon").

³¹¹ See, e.g., *Ryder Truck Rental v. Bryant*, 170 So. 2d 822, 825 (Fla. 1964) (tax can be imposed on both purchase and lease of same equipment, since purchase and lease are two separate transactions.); *Boise Bowling Ctr. v. State*, 461 P.2d 262, 265 (Ida. 1969) ("There is no double taxation when two separate and distinct privileges are being taxed even though the subject matter to which each separate transaction pertains may be identical.").

Credit may not be allowed against local taxes.³¹² The credit formula may not allow full recovery of the amount paid.³¹³

VI. STATE PROPERTY/REGISTRATION TAX

A. THE GENERAL RULES

In about one-third of the States, aircraft are subject to property tax, which is an annual tax which is generally equal to a percentage of aircraft value.³¹⁴ In another third of the States, aircraft are subject to an annual registration tax, which is in lieu of the property tax.³¹⁵ In the remaining one-third of the States, aircraft are exempt from property tax or registration tax.

1. *Property Tax*

Generally, an aircraft operated under Part 91 is subject to property tax entirely in the State where the aircraft is based. In order for another State to impose an apportioned tax, the State must be able to show that the aircraft has acquired a "situs" in the State. Conversely, in order for the owner to avoid paying tax on any portion of the aircraft, the owner must be able to establish that the aircraft has obtained a taxable situs in another State.³¹⁶

The tax is generally imposed on the registered owner of the property. However, the lessee of property may be taxed where the transaction is determined to be a conditional sale of the property.³¹⁷

Because airline property will generally have a taxable situs in several States, the State property tax laws generally have a statu-

³¹² See, e.g., MINN. STAT. § 297A.80 (2001).

³¹³ Some States allow a credit based on the ratio of the State rate to the rate in the other State. See, e.g., MINN. STAT. § 297A.80 (2001). This formula does not take into account the possibility that the tax in the other State, while at a lower rate, was imposed on a higher taxable amount. This could happen where, for example, the other State did not allow a trade-in credit.

³¹⁴ Based on the author's experience, the tax amount is generally somewhere between 1 to 3% of the fair market value of the aircraft.

³¹⁵ Based on the author's experience, the tax amount is generally somewhere between a few hundred dollars to 1% of the fair market value of the aircraft.

³¹⁶ See, e.g., *Peabody Coal Co. v. State Tax Comm'n*, 731 S.W.2d 837 (Mo. 1987).

³¹⁷ See, e.g., *Alban Tractor Co. v. State Tax Comm'n*, 150 A.2d 456 (Md. 1959); *Custom Leasing Co. v. Limbach*, 577 N.E.2d 348 (Ohio 1991); *City of Milwaukee v. Shoup Voting Mach. Corp.*, 196 N.W.2d 694 (Wis. 1972).

tory provision requiring apportionment of value.³¹⁸ Some States have extended this requirement to charter aircraft.³¹⁹ A couple of States allow apportionment for aircraft operated under Part 91.³²⁰ Where there is a fleet of aircraft, the States will often compute apportioned value based on the activity of the entire fleet (the “unit value method”).³²¹

2. Aircraft Registration Tax

The aircraft registration tax is generally imposed on the registered owner of the aircraft. The amount and computation of the tax varies widely. In some States, the tax is based on value or original cost.³²² In other States, the tax is based on number of seats or engines or useful load.³²³

The treatment of residents and nonresidents is often significantly different. Where an aircraft owned by a resident is located in the State, the registration tax is generally imposed regardless of how long the aircraft has been in the State.³²⁴

³¹⁸ See, e.g., CAL. REV. & TAX. CODE § 1152 (West 2002); OR. REV. STAT. § 308.505 (2001); TENN. CODE ANN. § 67-5-1301 (2001); TEX. TAX CODE ANN. § 21.05 (Vernon 2002); UTAH CODE ANN. § 59-2-401 (2002); WASH. REV. CODE ANN. § 84.12.200 (West 2002).

³¹⁹ See, e.g., NEV. ADMIN. CODE ch. 361, § 4685(2) (2001).

³²⁰ These States are Missouri and Texas. Missouri treats all aircraft over 7,000 lbs. as commercial aircraft. See MO. ANN. STAT. § 155.010(4) (West 2002). Texas allows apportionment of value for business aircraft. See TEX. TAX CODE ANN. § 21.055 (Vernon 2002).

³²¹ The Supreme Court allowed the use of this method in *Braniff Airways, Inc. v. Nebraska State Bd. of Equalization and Assessment*, 347 U.S. 590 (1954). The “unit value” method appears to have been adopted in the late 1800s for the purpose of valuing property of railroad companies. Debra M. Gabbard, *Taxation of Public Service Companies Providing Utility Service* (Oct. 1998) (“Public service companies are valued under the unit valuation rule. Unit valuation originated during the late 1800’s when it was determined that it was impossible to accurately value the property of a railroad by looking at individual lines of track, not to mention the locomotives and carlines which are a constantly moving target. The concept of valuing the entire railroad and then apportioning some of that value to each taxing district was put into place. Now 27 States use unit valuation to estimate the value of large multicounty and multistate public service companies.”).

³²² See, e.g., ARIZ. REV. STAT. § 28-8335 (1997) (taxable value is average fair market value of particular make, model, and year of aircraft); MINN. STAT. § 360.531 (1999) (taxable value is list price reduced by a specified percentage per year of ownership).

³²³ See, e.g., IDAHO CODE § 21-114 (Michie Supp. 2001) (useful load); IND. CODE ANN. § 6-6-6.5-13 (Michie 2002) (age, class, and maximum landing weight).

³²⁴ See, e.g., IND. CODE ANN. § 6-6-6.5-2(a) (Michie 2002) (“any resident of this state who owns an aircraft shall register the aircraft with the department not later than thirty-one (31) days after the purchase date [and] any nonresident who

However, where the aircraft is owned by a nonresident, the law generally requires that the aircraft be used in the State for a certain number of days before the tax applies.³²⁵

B. CHARACTERIZATION OF FRACTIONAL PROGRAMS

Generally, for property and registration tax purposes, the only thing that matters is who owns the aircraft. While the State tax authorities might want to argue that either the selling company or the management company is the owner of all of the aircraft, there does not appear to be a good basis for reaching this conclusion. Presumably, the interest owners will be considered the joint owners of each aircraft.

C. CONSEQUENCES AND REMAINING ISSUES

As in the case of the sales and use tax, there are many unanswered questions. However, in this case, the likely answer is that the aircraft will not be subject to tax.

1. *Property Tax*

In order for a State to impose property tax, the aircraft must have a situs with the State. As noted previously, the States themselves have tended to require a fairly high level of activity to create situs, in some cases holding that using property 33% of the time in a particular State is not enough to create situs in that State.³²⁶ As a practical matter, a fractional aircraft used in a nationwide fractional program will generally not spend enough time in a particular State to create situs.

bases an aircraft in this state for more than sixty (60) days shall register the aircraft with the department under this chapter not later than sixty (60) days after establishing a base in Indiana"); OR. REV. STAT. § 837.040 (2001) ("every resident owner of any civil aircraft, physically capable of operation or flight as determined by the Director of the Oregon Department of Aviation, when such aircraft is located in this state or before it is operated or flown over the lands or waters of this state . . . shall cause to be filed with the Oregon Department of Aviation, an application for registration of the aircraft . . .").

³²⁵ See, e.g., ARIZ. REV. STAT. § 28-8336 (1997) (more than 90 days); IND. CODE ANN. § 6-6-6.5-2 (West 2002) (60 days after establishing a base in Indiana); LA. REV. STAT. ANN. § 2:2 (West 2001) (more than 90 days).

³²⁶ See, e.g., *Peabody Coal Co. v. State Tax Comm'n*, 731 S.W.2d 837 (Mo. 1987).

2. *Aircraft Registration Tax*

The likelihood that an aircraft registration tax will be imposed appears equally remote. The major States do not have a registration tax.³²⁷

VII. CONCLUSION

The tax treatment of fractional programs for transportation tax and income tax purposes seems to be fairly well settled. Where the fractional program primarily involves operations in a single State, the State tax treatment will generally be settled by reference to the laws of that State.

In the case of a multistate fractional program, the Constitutional and State limitations and exclusions may work together to prevent imposition of any State taxes. While this might seem to give fractional programs an unfair advantage over other Part 91 aircraft, it should be recalled that Part 91 aircraft are not subject to the transportation tax. Perhaps, in an unintended way, justice is being done.

³²⁷ California and Texas have a property tax. Florida, Illinois and New York have no property tax or registration tax on aircraft.

